

Stark III: The Indirect Compensation Two-Step

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Practice Area: Health Law

The new Stark III rules include a major reversal by the Centers for Medicare and Medicaid Services ("CMS") on the method used to analyze financial relationships between physician groups, on the one hand, and hospitals and other providers of designated health services ("DHS"), on the other. Sometimes referred to as the "stand in the shoes" doctrine, this new approach requires the reassessment of many financial relationships with physician practices that previously were considered either to (a) meet the terms of Stark's exception for indirect compensation arrangements; or (b) fall outside the scope of Stark's referral prohibitions altogether. This change affects not only how these arrangements are structured in the future, but also how they are tracked and reported for compliance purposes.

Background

The basic premise of the Stark law is that a physician may not refer DHS to entities with which the physician has a financial relationship, unless an exception applies. Financial relationships may be either direct (no intervening entity between the DHS entity and the referring physician) or indirect (one or more intervening entities); and may involve either a compensation arrangement or an ownership or investment interest. Different exceptions are available depending on whether a relationship is direct or indirect, and on whether the relationship involves a compensation arrangement or an ownership/investment interest. The exceptions for direct compensation arrangements include such items as employment, personal services, and leases.

Prior to Stark III, a contract between a DHS entity and a physician practice was analyzed under the rules and exception applicable to indirect arrangements, not direct arrangements. Take for example a hospital's lease of office space to a physician group. Stark includes an exception for space leases that requires, among other things, (a) a written agreement of at least one year duration; (b) rent that is set in advance, consistent with fair market value, and determined in a manner that does not take into account the volume or value of referrals or other business generated between the parties; and (c) limitations with respect to the amount of space and the apportionment of common areas. Under Stark II, this exception applied if the hospital was leasing directly to an individual physician, but not if the lease was with the practice group. Since the practice constitutes an intervening entity, the latter arrangement needed to be analyzed as a potential indirect arrangement; compliance with the lease exception was essentially irrelevant.

Stark II included an exception specifically applicable to indirect compensation arrangements. That exception focuses on the compensation arrangement closest to the referring physician. The exception required among other things that compensation be fair market value, and not determined in a manner that takes into account the volume or value of referrals or other business generated between the parties. The exception did not contain many of the criteria typically found in direct compensation exceptions, however, such as a minimum term or a requirement that compensation be set in advance.

The surprising result under Stark II was that a contract with a physician practice might fall totally outside of Stark's referral prohibitions, so that reliance on the indirect compensation exception also became unnecessary. That consequence flowed from the definition of an indirect compensation arrangement, which requires not only a chain of relationships between the hospital and referring physician, but also that the remuneration in the compensation arrangement closest to the physician varies with or otherwise reflect, in the aggregate, the volume or value of referrals or other business generated between the parties. So in the lease example mentioned previously, no indirect compensation arrangement would arise between the hospital and the physician-employees in the practice so long as the physician's aggregate compensation as an employee did not vary with or reflect referrals to the hospital; and no indirect relationship would arise as between the hospital and the physician-owners of the practice so long as the rent under the lease (the closest compensation arrangement to the physician-owners) also did not vary with or reflect referrals, as in a fixed-rate lease. In that situation, it would not be necessary to comply with either the lease exception (since it's not a direct compensation relationship) or the indirect compensation exception (since it's not an indirect compensation arrangement).

CMS Reverses Course

Stark III represents a complete turnabout on the characterization of financial arrangements between DHS entities and physician groups. Under this new rule, physicians will be deemed to "stand in the shoes" of their physician practices, so that a contract with a group is treated as if it were a contract directly between the hospital and each individual physician in the practice. Treating these arrangements as direct instead of indirect relationships has two potential consequences. First, this approach may implicate many contracts that previously fell outside the reach of Stark's referral prohibitions. As in the lease example above, a contract that previously did not qualify as either a direct or indirect relationship may now be classified as a direct compensation arrangement that is subject to Stark. Second, these contracts with physician practices will now have to meet the exceptions applicable to direct arrangements, such as the lease exception discussed above, rather than the exception applicable to indirect arrangements.

CMS states that this change is meant to address an "unintended loophole," but this characterization is difficult to square with the history of Stark I and II. At the time that it published the Stark II interim rules, CMS acknowledged numerous recommendations from the industry that financial arrangements between DHS entities should be permitted so long as they met the terms of the corresponding exception for direct relationships. CMS rebuffed that approach, repeatedly stating that these agreements needed to be analyzed as potential indirect compensation arrangements and that the direct exceptions were simply inapplicable. In Stark III CMS embraces what it previously rejected. Direct exceptions that were irrelevant are now compulsory.

Significance

The practical reality is that the stand-in-the-shoes doctrine may not require a major change in procedure for a sizeable segment of the industry. Whether through foresight or fortuity, most hospitals and other DHS entities were already structuring contracts with physician groups so that they met the terms of the corresponding direct exception. And indeed, compliance with the more stringent terms of the direct exceptions generally assured compliance for indirect relationships as well. But for entities that had parsed the intricacies of indirect compensation arrangements under Stark II, and had relied on the distinctions that are now erased under Stark III, restructuring may now be in order.

Return once again to the lease example, this time involving an oral lease of space to a physician group on a month-to-month basis for a fixed-rate market rental. Under Stark II, that lease would not constitute either a direct or an indirect compensation arrangement between the hospital and the physicians in the group, placing it outside of Stark's reach. Under Stark III, however, the agreement will be treated as though it were a lease directly between the hospital and each of the physicians in the practice. That lease would not meet the terms of the Stark lease exception (since it is not in writing, and is for a term of less than one year), nor would it meet the exception for fair market value arrangements (which also requires a written agreement, and is not available for space leases in any event). As a result, this lease would need to be restructured before the effective date of Stark III.

One benefit of this revised approach is that DHS entities no longer need to be concerned with the manner by which a practice group compensates its physicians. Under the former indirect approach, the proper characterization of a financial relationship and the eligibility for the indirect compensation exception both required an understanding of whether the individual physician's compensation varied with or otherwise reflected referrals of DHS or other business generated between the parties. Under Stark III, on the other hand, the practice's method of compensating a physician becomes irrelevant for purposes of determining compliance with an exception.

Open Questions

Since Stark does not require proof of intent in order to establish a violation of its referral prohibitions, CMS has repeatedly sought to deliver bright-line guidance that is free from ambiguity. The stand-in-the-shoes doctrine provides greater clarity in some respects by placing contracts with physician groups on the same footing as contracts with individual physicians. This approach also presents new questions and challenges, however.

While it is relatively easy to identify situations where the stand-in-the-shoes doctrine does apply, it is not entirely clear where it does not. Physicians stand in the shoes of their respective "physician organizations" – a new term under Stark III that is defined to include a physician, a "physician practice," or a "group practice." "Group practice" also is a defined term under Stark, but "physician practice" is not. Indeed, Stark defines a group practice as "a physician practice that meets [certain specified] conditions." Since Stark essentially defines group practices as a subset of physician practices, listing those terms separately in the definition of a physician organization is redundant at best.

The foregoing definition of group practices might suggest that the term "physician practice" is fairly all-inclusive (everything that is a group practice, as well as everything that is not), but the preamble to Stark III reveals a less encompassing intent. There, CMS states that it "considered defining a 'physician organization' to include entities other than a physician, physician practice, or group practice, but we have rejected that alternative...." CMS fails to reveal what other types of physician entities might fall outside of that definition, although at a different point in the preamble CMS implies that certain unspecified foundation-model structures might not qualify as a physician organization.

Stark III has already prompted debate among practitioners regarding what types of physician entities might fall outside of the definition of a "physician practice." One approach is functional in nature, focusing on whether the primary purpose of the entity is the delivery of patient services. Under this approach, physicians employed by a medical school arguably should not "step into the shoes" of their employer since the primary purpose of the entity is education, notwithstanding the fact that the physicians also maintain a patient practice. But that begs the question of how to define the threshold at which the practice of medicine becomes the primary purpose of an entity. Another approach might focus on the ownership structure of the entity. Is it necessary for physicians to "step into the shoes" of a nonstock, not-for-profit entity where no physician ownership is present? A strong argument can be made that the indirect compensation analysis under Stark II provided ample safeguards in this latter scenario, rendering the Stark III approach unnecessary.

There is another concern arising from this change in course by CMS, again tied to the strict liability nature of Stark. Stark II incorporated a knowledge element into the definition of an indirect compensation arrangement. No such knowledge element is present in the stand-in-the-shoes doctrine: a hospital or other DHS entity will be deemed to have direct financial relationships with every physician in the practice, whether or not it is aware that they are members of the group. This may place an affirmative duty on the DHS entity to determine the identity of every physician affiliated with that practice.

Tracking and Reporting

The new stand-in-the-shoes doctrine may impact the manner in which hospitals track and report their financial relationships with physician referral sources. In July of this year, CMS announced that it would require certain hospitals to prepare and submit information on physician ownership and compensation arrangements in order to determine whether they are in compliance with Stark. The selected hospitals are required to complete and submit a Disclosure of Financial Relationships Report ("DFRR") for financial relationships as of December 31, 2006.

On September 14, CMS posted an updated DFRR form on its website. This form requires disclosure of compensation relationships with physicians that fall under various direct compensation exceptions, but does not seek information on indirect compensation arrangements through physician groups. Given that the stand-in-the-shoes doctrine will not have any application until December 4, 2007 at the earliest (see below), it would appear that hospitals may complete the DFRR without regard to the step-in-the-shoes doctrine. In other words, hospitals need only identify leases and certain other listed compensation arrangements where the hospital has contracted directly with a referring physician, but need not list similar arrangements with a physician practice. Two exceptions involve personal services and recruiting arrangements with physician groups, which were the subject of direct compensation exceptions before Stark III and therefore are captured within the DFRR.

After December 4, however, hospitals will need to begin treating contracts with physician practices as though they were with each individual physician in that group. Hospitals will need to track (and be prepared to report) those individual financial relationships upon request. Hospitals that already have a tracking system in place will need to review their current procedures for identifying and reporting contractual arrangements with physician groups. For those hospitals that have yet to implement a tracking system, Stark III should serve as a wake-up call.

Grandfathered Relationships

The Stark III rules go into effect on December 4, 2007. CMS recognized that hospitals and other DHS entities may have structured financial relationships with physicians and physician groups in reliance on the indirect compensation methodology of Stark II. As a result, for any indirect compensation arrangement that met the terms of the indirect compensation exception as of September 5, 2007 (the publication date of the Stark III rules), the new step-in-the-shoes doctrine will not apply until the end of the current term of the agreement. Going back to the lease example, if a hospital has a lease with a group practice that did not meet the lease exception (for instance, because it was for a term of less than a year), but which otherwise met the exception for indirect compensation arrangements, that lease will not need to be restructured to qualify for the lease exception until the end of its current term. The "current term" is determined as of the published date of Stark III on September 5; so if an arrangement renews between September 5 and December 4, it will have to meet the stand-in-the-shoes criteria as of December 4.

This transitional rule only applies to arrangements with physician practices that qualified for the indirect compensation exception as of September 5, 2007. It does not apply to arrangements with practice groups that did not constitute an indirect compensation arrangement at all. Those latter arrangements will be treated as direct compensation arrangements with the physicians in the group as of December 5, with no deferral.

The Bottom Line

Hospitals and other DHS entities should commence a review of all compensation arrangements with physician practices to verify whether they meet the terms of an existing direct compensation exception. For any arrangement that does not qualify under a direct exception, further analysis is required to determine whether the agreement satisfies the exception for indirect compensation arrangements so that it is grandfathered during the balance of its current term. The results of this analysis should be incorporated into an effective tracking mechanism to ensure ongoing compliance, and to provide the ability to report physician financial relationships upon request. All non-grandfathered arrangements should be restructured or terminated prior to December 4, 2007.

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