Stark Law Update: Phase III Rule

CMS recently published its Phase III regulations under the federal Stark law, which became effective on December 4, 2007. Phase III is significant because it clarifies many issues under the Stark law. Below is a brief summary of the notable changes and clarifications as they may apply to joint venture models described in Hospital–Physician Strategic Ventures.1

“Stand in the Shoes”

A significant change introduced by Phase III is the “stand in the shoes” concept. This affects compensation relationships between physicians and the entity providing designated health services (“DHS Entity”), usually a hospital. Phase III now deems a physician owner, employee or independent contractor to “stand in the shoes” of his “physician organization” (as defined below), as long as the only intervening entity between the physician and the DHS Entity is his physician organization. A “physician organization” is a physician (including a professional corporation owned by the physician), a physician practice, or a group practice as such term is defined by the Stark law. The term “physician practice” is not further defined, thereby creating some ambiguity as to the exact meaning (and hence breadth) of the term “physician organization.”

For example, prior to the introduction of the “stand in the shoes” concept, a physician group that leased office space from a hospital (the DHS Entity) could have relied on the indirect compensation arrangement exception to Stark because the physicians’ financial relationship to the DHS Entity was indirect through ownership in their medical practice (which in turn had a compensation relationship with the hospital, namely the lease). Under Phase III, each physician in that group is deemed to be one and the same as his medical practice and thus has a direct compensation relationship with the hospital (the DHS Entity). Thus, the indirect compensation arrangement exception is no longer available in this scenario and the parties now have to rely on a direct exception to Stark (in this example, the space lease exception).

A limited grandfather clause permits arrangements entered into prior to September 5, 2007 to continue without amendment during the current term of the arrangement. Thereafter, the agreement will need to be revised to comply with Phase III. After the introduction of Phase III, CMS also announced a one-year delayed effective date for the “stand in the shoes” provision as it applies to academic medical centers.

The “stand in the shoes” provision will likely not affect investment by physicians in equity and under arrangement joint ventures as long as the joint venture entity or “Newco” is not a physician organization. Thus, for example, with respect to the under arrangement joint venture model,2 because Newco is arguably not a medical practice (or physician organization) of the physician investors, the “stand in the shoes” concept should not affect their investment in the joint venture entity. Further, the physicians should likely be able to continue to use the indirect compensation arrangement exception to protect their investment in Newco and Newco’s services agreement with the hospital (the DHS Entity).

CMS acknowledges that “categorically prohibiting physician practices from imposing non-compete provisions may have the unintended effect of making it more difficult for hospitals to recruit physicians.” Accordingly, CMS has clarified the types of practice restrictions that do not unreasonably restrict the recruited physicians’ ability to practice medicine in the geographic area served by the hospital. These include restrictions on moonlighting, reasonable non-competes and non-solicitation clauses (i.e., that will be upheld under applicable state law), a requirement to treat Medicaid and indigent patients, a requirement to repay certain losses of the practice, and a requirement to pay reasonable liquidated damages.

“Stand in the shoes” may, however, affect physician investment in the service line management joint ventures if the Newco in that model is a physician organization of the physicians. Accordingly, to comply with Phase III, each physician owner will need to satisfy a relevant direct Stark law exception to protect his or her investment in Newco and Newco’s services agreement with the hospital (the DHS Entity), such as the personal services exception.

Space and Equipment Rentals

Phase III clarifies that amendments to the rent or other lease terms that are material to rental charges may only be accomplished by term...

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2 CMS has indicated that with respect to under arrangement joint ventures, it intends to explore further changes to the Stark law to curb the proliferation of these ventures, many of which in CMS’ view, are set up solely as mechanisms to transfer hospital revenues to referring physicians.
ominating the original lease and entering into a new lease, provided that the new lease may not be entered into during the first year of the original lease term.

Thus, any amendments to space and lease agreements between Newco and the hospital and/or physician investors will need to be carefully scrutinized going forward.

**Personal Service Arrangements**

Similar to leases, among other changes, CMS clarified that amendments to the compensation and related provisions in a personal service arrangement may be accomplished only through a new agreement, and not during the first year. Thus, amendments to any joint venture agreements involving personal service agreements will need to be carefully monitored to ensure continued compliance.

In addition, Phase III added a provision similar to that in the space and equipment lease exceptions that now permits a holdover of a personal services arrangement on the same terms as the original agreement, for up to six months after expiration.

**Physician Recruitment**

Phase III has expanded this exception to now permit physician recruitment by Federally Qualified Health Centers (FQHCs). In addition, Phase III amends the definition of “service area” so that a hospital may recruit physicians from a broader geographical area. Thus, if a hospital draws less than 75 percent of its inpatients from all the contiguous zip codes from which it draws inpatients, its service area can now include all of the contiguous zip codes from which it draws inpatients, even if it does not draw 75 percent of its inpatients from those zip codes. Further, the service area can now include a zip code from which the hospital gets no patients if it is surrounded by contiguous zip codes from which the hospital draws 75 percent of its inpatients.

CMS also clarified that: (i) a rural hospital may determine its service area based on the lowest number of contiguous zip codes from which it draws at least 90 percent (in lieu of 75 percent) of its inpatients; and (ii) a hospital may use different geographic service areas for different recruitment arrangements as long as the service area requirement is satisfied on the date the hospital enters into the recruitment agreement.

Phase III clarifies that the relocation requirement is a two-part test requiring the recruit to both move his practice from outside to inside the service area, and also meet either the 25-mile or 75 percent of revenues test. Phase III broadened the group of physicians not subject to the relocation requirement to include physicians who were employed on a full-time basis for the 2 years prior to the recruitment agreement by a federal or state prisons bureau, the Departments of Defense or Veterans Affairs, or a facility of the Indian Health Service.

Notably, in Phase III, CMS acknowledges that “categorically prohibiting physician practices from imposing non-compete provisions may have the unintended effect of making it more difficult for hospitals to recruit physicians.” Accordingly, CMS has clarified the types of practice restrictions that do not unreasonably restrict the recruited physicians’ ability to practice medicine in the geographic area served by the hospital. These include restrictions on moonlighting, reasonable non-compete and non-solicitation clauses (i.e., that will be upheld under applicable state law), a requirement to treat Medicaid and indigent patients, a requirement to repay certain losses of the practice, and a requirement to pay reasonable liquidated damages.

**Practical Recommendations**

The following recommendations may be helpful to ensure continued compliance with the Stark law:

- Review all existing joint venture arrangements to determine the specific Stark law exception that each relied on. Many joint ventures involve ancillary agreements between the investors (for example, leases and services agreements). Some of these arrangements may have previously relied on the indirect compensation exception and will now need to satisfy a direct compensation exception under the “stand in the shoes” concept.
- To the extent amendments are being considered to any ancillary services agreements (e.g., space or equipment leases or personnel services), keep in mind that certain types of amendments (e.g., changes to rent/compensation) require that a new agreement be entered into.
- Carefully review existing physician recruitment arrangements. Some of the more significant changes and clarifications introduced by Phase III were to the physician recruitment exception. For example, some hospitals may now have the option to broaden the scope of their geographic service areas and this, in turn, may require an update of their community needs assessment reports and/or fair market value opinions.

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