

Real Estate

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Stark II, Phase II: Impact on the Rental of Office Space and Equipment Exceptions

INTRODUCTION

On March 26, 2004, the Centers for Medicare & Medicaid Services (“CMS”) issued the long-awaited second part (“Phase II”) of its three-part regulations implementing certain provisions of the Federal physician anti-referral law known as the “Stark Law.”¹ CMS published Phase II as an interim final rule with a 90-day comment period. Phase II will become effective on July 26, 2004.

Given their extensive coverage and scope, the Phase II regulations will have important implications for physicians, hospitals and other health care providers in a variety of settings and relationships. This is the first in a series of Alerts we intend to circulate in the upcoming months regarding the newly issued regulations. The purpose of this initial Alert is to discuss two of the statutory exceptions dealt with in Phase II which impact the real estate and leasing arenas, those being the exceptions for rental of office space and equipment, and to introduce the new “temporary non-compliance” exception.

EXCEPTIONS FOR RENTAL OF OFFICE SPACE AND EQUIPMENT

The Stark Law provides exceptions from the general rule of referral prohibition for leases or rental

arrangements involving office space and equipment.²

According to Sections 411.357(a) and 411.357(b) of the Phase II regulations, a lease or rental of office space or equipment will not constitute a financial relationship in violation of the Stark Law if the following requirements are satisfied:

1. The rental or lease agreement is set out in writing, is signed by the parties, and specifies the premises or equipment covered by the agreement.
2. The term of the agreement is for at least one year. If the agreement is terminated during the first year of the term, with or without cause, the agreement will still satisfy this requirement so long as the parties do not enter into a new rental or lease agreement during the first year of the term of the original agreement.
3. The space or equipment rented or leased does not exceed that which is reasonable and necessary for lessee’s legitimate business purposes, and the space or equipment is used exclusively by the lessee (and is not shared with or used by the lessor or any person or entity related to the lessor).

Notwithstanding the foregoing, with respect to real property leases, the lessee may make payments for the use of common areas if the payments do not exceed the lessee’s pro rata share of expenses for the space.

¹ The first part of the final regulations interpreting Stark II (“Phase I”) were finalized and published on January 4, 2001 as a final rule with comment period and became effective on January 4, 2002. After taking more than three years to digest the many comments received during the Phase I comment period, CMS released Phase II of its three-part regulations. The Phase I and Phase II rules are intended to be read together as a unified whole, thus providing physicians and entities providing designated health services with a more uniform and complete set of rules to follow.

² The Phase I and Phase II regulations revised several key definitions of terms used in the exceptions involving office space and equipment, including “fair market value,” “set in advance,” “volume or value of referrals,” and “other business generated between the parties,” and a working understanding of these definitions is crucial in interpreting the exceptions.

4. The rental charges over the term of the agreement are set in advance and are consistent with fair market value.
5. The rental charges over the term of the agreement are not determined in a manner that takes into account the volume or value of any referrals or other business generated between the parties.
6. The agreement would be commercially reasonable even if no referrals were made between the lessee and the lessor.
7. A holdover month-to-month rental for up to 6 months immediately following an agreement of at least one year that meets the above conditions will satisfy these requirements, provided the holdover rental is on the same terms and conditions as the prior agreement.

CHANGES FROM PROPOSED REGULATIONS

Phase II adopts the majority of the provisions of the 1998 proposed rule relating to space and equipment leases, as well as implementing new provisions that arguably make the law less stringent for physicians and entities providing designated health services (“DHS”).³ The highlights of the final rule are set forth below.

- *Termination of Leases Without Cause.* The proposed regulations interpreted the one-year term requirement as permitting leases to be terminated for cause during the first year of the lease, but did not allow without cause terminations during such time period. Phase II provides that leases or rental agreements can be terminated with or without cause during the one-year period, as long as the parties do not enter into a new lease or rental agreement within the first year of the original lease term. This change should ensure that a without cause termination will not result in the disqualification of an otherwise compliant lease or rental agreement.
- *Holdover Leases.* The proposed regulations suggested interpreting the one-year term

requirement to require any renewal of a lease to be for at least one year, thereby precluding holdover month-to-month leases. Phase II provides that month-to-month holdover leases are allowed for up to six months if they continue on the same terms and conditions as the original lease, including the amount of rental. This change could prevent a technical violation of the statute if, for example, a lease between a physician and hospital expires and the physician does not vacate the leased premises before a new lease is executed. However, qualifying entities should carefully review their existing leases as many boilerplate holdover provisions in leases provide for increases in rental if the tenant holds over, which could result in a violation of the statute.

- *Capital Versus Operating Leases.* The proposed regulations interpreted the exceptions as only applying to operating leases, but not capital leases. Phase II provides that all leases or rental agreements, whether operating or capital, are eligible for the lease exceptions. This change should ensure that a bona fide lease arrangement that in form and substance satisfies the regulatory criteria can now fit into the exceptions.
- *“Exclusive Use” Provision.* The proposed regulations interpreted the exclusive use provisions of the statute to prohibit subleases, unless the sublease itself satisfied the criteria for the exception. Phase II revises the exclusive use provision to allow subleases so long as the lessee or sublessee does not share the rented space or equipment with the lessor (or any person or entity related to the lessor) during the time it is rented or used by the lessee or sublessee.⁴
- *“Per Click” Rental Payments.* The proposed regulations provided that “per click” equipment rental payments would qualify for the equipment rental exception, unless the payments were for the use of the equipment on patients referred by the lessor-physician. “Per click” rental payments are

³ Depending on the circumstances, Phase II provides that equipment leases may also circumvent the general prohibition on referrals by qualifying under the new fair market value exception. The fair market value exception applies to arrangements, in writing, for the provision of items and services by physicians provided directly or through employees. However, that exception is limited to items and services provided by physicians, and does not include leases of real property.

⁴ A sublease arrangement may cause other problems for the parties under the Stark Law, such as an indirect compensation arrangement between the lessor and the sublessee, and such an arrangement should be evaluated under the indirect compensation rules.

permitted for DHS referred by the referring physician as long as the payments are fair market value and do not take into account the volume or value of referrals or other business generated by the referring physician.

NEW TEMPORARY NON-COMPLIANCE EXCEPTION

Phase II also creates a new exception to the general referral prohibition for entities that temporarily fall out of compliance with the Stark Law due to events beyond their control. This exception, similar to a grace period, applies when a change in circumstance places an entity or a referral outside the protection of an exception that it previously met, provided that the entity formerly complied with the exception for at least 180 days immediately preceding the date on which the arrangement became non-compliant. Although the “temporary non-compliance” exception may only be used sparingly, once every three years per entity with respect to referrals from a particular physician, this new exception may be helpful to physicians or health care providers that temporarily fall out of compliance with

one of the exceptions for leases or rental arrangements involving office space and equipment.

CONCLUSION

The changes to the Stark Law embodied in the Phase II regulations could have serious implications for physicians, hospitals and other health care providers in their existing real estate and equipment leases and in future relationships. Additionally, many industry observers believe the enforcement effort is likely to increase now that a final rule exists. Given the approaching effective date of July 26, 2004, all covered entities should review their current relationships to ensure compliance with the final rule.

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