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Lease Creep, Ground Leases: Real Estate Stark Risks May Be Overlooked

By Nina Youngstrom

When hospitals lease space to physicians, they may give them tenant improvement allowances, a dollar amount per square foot to customize and enhance the office space. But tenant improvement allowances are a little dicey under the Stark Law. Whether they're commercially reasonable is open to question in some cases because the tenant improvement allowance could swallow up most of the landlord's rent revenue if the space is small and the lease is short, although the loss in revenue may be acceptable because upgrading the space will make it more marketable to the subsequent tenant. This is a calculation hospitals have to make when deciding whether to provide tenant improvement allowances to tenants who are referring physicians and, if so, how much, while keeping their eye on the fraud and abuse laws.

"It's one way remuneration can happen," says attorney Goran Musinovic, vice president of Realty Trust Group in Knoxville, Tennessee.

That's an example of the messy business at the intersection of real estate and the Stark Law. Although hospitals tend to worry how their compensation relationships with referring physicians may run afoul of Stark, they are just as vulnerable because of their leases, Musinovic says. The details, such as lease creep, could be their undoing, or it may be in the bigger arrangements, like ground leases. Hospitals may wind up in a bind because their expertise and their departments are siloed, Musinovic says. Hospital executives who oversee physician arrangements may not be well versed in real estate, and the people managing real estate may not be that aware of the Stark nuances, he says. That's a problem, especially because leases are often implicated in Stark-based False Claims Act settlements ("In $4M FCA Case, Hospital Disclosed, But Whistleblower Was First," *RMC* 26, no. 33; "Mich. Hospital Settles FCA Case for $84.5M Over Physician Payments," *RMC* 27, no. 29).

"You have transactional and operational pitfalls," Musinovic says. Transactional pitfalls are associated with the way the transaction (e.g., the lease) has been structured and whether it meets exceptions under the Stark Law, including the rental of office space, time-share arrangements or indirect compensation arrangements, which require, in part, the leases to be commercially reasonable and consistent with fair market value (FMV). Operational pitfalls emerge when hospitals execute leases. "If you fail to execute an arrangement in accordance with its terms, you can be committing violations," Musinovic says.

There are three types of leases, says attorney Bob Wade, with Barnes & Thornburg in South Bend, Indiana. They are:

- **Gross rent:** All expenses, including utilities, taxes and maintenance, are included in the rent.
- **Triple net rent**: Rent per square foot is lower than tenants pay with gross rent, but they pay for common area maintenance in addition to rent.
- **Modified triple net:** The most common version is a certain amount charged per square foot with increases from the baseline for common area maintenance.

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"I am a strong advocate for establishing all lease agreements to be gross," Wade says. "You need to be very clear with tenants what you're providing." Is it commercially reasonable to provide the services, including garbage removal, cleaning, security and phone service? The answer is presumably yes, and then, when determining FMV, hospitals have to ensure they take into account all the services provided.

Ground Leases May Lack FMV Support

Ground leases may be vulnerable to allegations of Stark violations. This comes up when a hospital owns land and leases it to a developer with physician ownership to build a medical office building (MOB). "Hospitals want to control the real estate asset, but they don't necessarily want to have all their money tied up in real estate," Musinovic explains. After the building is built, the hospital and independent physicians often lease space from the developer, he says. If the developer has physician ownership, the ground lease rates have to be FMV and take into account all the materials terms of the lease. "We have seen hospitals enter into ground lease arrangements with developers for nominal sums (e.g., $1 per year) and long lease terms (e.g., 50-100 years) without having any FMV support," he says. "There are a lot of risks there if the developer has physician owners because the ownership by those physicians could trigger the Stark Law, in which case the ground lease would have to meet an exception under Stark, such as the indirect compensation arrangements exception."

Just like a mall developer, the MOB developer wants to attract marquee physician tenants, such as a high-profile cardiology group, and may be tempted to offer terms that may not be the average rate for other space in the MOB, Wade says. For their part, the physicians know they have bargaining power and will try to get the best deal possible. As a result, the developer, which may be the hospital or a joint venture, offers the bottom of the FMV range, which may be, for example, 10% below the average rental rate in the MOB, he says. "They don't want to build an MOB on a hope and a prayer they will fill the building, so they take the risk," Wade explains. But the developer better have solid documentation to try to justify offering less than the average rent to lock in the high-value tenant.

Lease creep is another risk under the Stark Law. Suppose there are two physician practices on the same floor, and when one moves out, the remaining practice takes over some of the vacant space without paying more rent. "If the hospital knows about it or condones it, it's a compliance problem," Wade says. Although the director of real estate may insist it's not a problem until another tenant moves in, he or she would be wrong. "The hospital has knowledge the practice is creeping into that space and isn't charging for it," he says. However, if the hospital is unaware of the lease creep, "I don't believe you have a per se Stark violation. It's not an approved use by the administration. That's theft of that space," Wade says. "I don't think you have a Stark violation until you reach the point of knowledge." He likens it to an anesthesiologist who steals narcotics. "Is that a financial arrangement that implicates the Stark Law?" Doubtful, because it's stealing. "The only caveat is if the hospital fell asleep with respect to the management of the medical office building," Wade says.

Tips for Improving Real Estate Compliance

There are other ways that hospitals could run into trouble with leases, Musinovic says. For example, hospitals may not collect all the rent due from tenants who are referring physicians. Maybe the hospital doesn't accurately escalate rent, or physicians pay rent late and the hospital doesn't collect late fees that must be collected per the terms of the applicable lease arrangement. Or the two parties have a dispute about the lease, and the physicians withhold rent, and after they come to terms, the physicians pay a sum less than they should have paid under the lease. In all these situations, rent can fall below FMV, pushing the lease outside the Stark exception, "or the parties may be entering into a new financial arrangement that does not satisfy an applicable Stark Law exception," he explains.

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Hospitals also have to be careful of off-lease benefits, including sharps collection services and disposal of hazardous waste, Musinovic says. They can be expensive, and if they're not reflected in the rent, the stated lease rate may no longer be FMV.

Here are his tips for health systems to improve real estate regulatory compliance (see checklist, below):

- Take an inventory of all leases with referral sources. "Then you can begin to wrap your head around the universe of leases that can expose you to liability," Musinovic says.
- Develop processes and procedures specific to real estate. That includes a process for entering lease arrangements and renewing them, and a document-creation process. Hospitals also need a rent collection policy requiring all rent to be collected in accordance with the lease terms and outlining a process for collecting rent, which should include escalating the issue to the hospital's legal department if the real estate department is unable to collect the rent.
- Set forth the requirements for obtaining fair-market valuations for leases and the qualifications for the experts who will perform them. "At a minimum, you want to obtain a narrow fair market value range for lease rates for each building in which you are leasing space" that will account for all the material terms of the transaction, such as tenant improvement allowances and off-lease benefits, Musinovic says.

Contact Wade at bob.wade@btlaw.com and Musinovic at gmusinovic@realtytrustgroup.com. ✧

Checklist for Evaluating Health System Real Estate Compliance

Here is a checklist to help health systems assess the quality of their real estate compliance program (see story, above). It was developed by Goran Musinovic, vice president of Realty Trust Group. Contact him at gmusinovic@realtytrustgroup.com.

Regulatory Compliance	Yes	No
Are staff who are tasked with the health system's real estate administration regularly trained on the applicable healthcare statutes and regulations, including the Anti-Kickback Statute and the Stark Law?		
Has the health system established a step-by-step leasing process approved by the health system's compliance department and counsel, and is that process followed by the health system's real estate department?		
Does the health system hire qualified third-party valuation experts to opine on the fair market value (FMV) lease rates that should be charged to physician tenants or rates that the health system should pay to physicians from whom the health system is leasing space?*		
Does the health system hire qualified experts, or has the health system established internal processes, to opine on the commercial reasonableness (CR) of lease terms involving physician tenants?		
Has the health system implemented guidelines for the information that should be included in the FMV and CR Opinion Reports, and has the health system established an internal review process for those FMV and CR Opinions?		
Does the health system obtain these same FMV and CR Opinions when purchasing or selling properties to parties that may implicate the Stark Law or other healthcare regulations?		

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Do the FMV lease rates charged to physicians consider the terms of the lease, the size of the space, the tenant improvement (TI) allowance provided to a tenant, and other benefits/concessions under the lease?		
Has the health system obtained professional opinions from reputable third-party valuation experts regarding TI caps and rent escalator caps?		
Does the health system hire qualified third-party valuation experts to regularly perform Competitive Market Analysis (CMA) for the markets in which its properties are located?		
Has the health system implemented guidelines for the information that should be included in CMAs, and has the health system established an internal review process of those CMAs?		
Internal Controls	Yes	No
Has the health system established internal controls to ensure that the name/form of the lease (e.g., lease labeled as Triple Net [NNN] lease) used with physician tenants matches the substance of the lease (e.g., substantive content of the lease shows that it is an NNN lease)?		
Has the health system established internal controls regarding TI allowances to ensure they are not excessive under the circumstances?		
Has the health system established internal controls to ensure that leases do not lapse and are timely renewed?		
Does the health system have internal controls to ensure all rents are collected timely?		
Does the health system have internal procedures in place to ensure that leases are timely terminated in the event of default, and eviction procedures are undertaken when necessary?		
Standard Business and Lease Terms	Yes	No
Does the health system use standard business and lease terms for all tenants?		
Have the health system's standard business and lease terms been reviewed and approved by the health system's compliance department and counsel?		
Has the health system established a standard business and lease terms approval process, and is that process regularly followed by the health system's staff?		
Are all leases to which the health system is a party recorded in writing and reduced to a single document?		
Do all lease arrangements contain a term of a year or more?		
Are all lease arrangements signed and dated by the proper parties to ensure that no arrangements are backdated or retroactively signed?		

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Does the lease arrangement clearly identify the space, including common area space, used by the physician?		
General Compliance	Yes	No
Are staff who are tasked with the health system's real estate administration regularly trained on the different types of existing leases (e.g., Full Service Gross [FSG], Modified Gross, NNN) and other terms of art regarding leases (Usable Square Feet [USF] v. Rentable Square Feet [RSF], etc.)?		
Does the size of the space that is (a) leased from the health system by physicians or (b) leased by the health system from physicians exceed that which would be needed for a tenant to use it for its intended purpose?		
Is the size of the leased space that is considered in the health system's lease arrangements measured consistently (RSF v. USF), and are all suites measured in accordance with Building Owners and Managers Association (BOMA) industry standards across the health system's real estate portfolio?		
In establishing the terms of its lease arrangements with physicians, does the health system distinguish between referring physicians and nonreferring physicians?		
Does the health system include holdover provisions in its leases, including a provision that addresses a situation in which the tenant remains in the space after the expiration of the lease? Is the holdover clause in compliance with the 2016 Stark Law update?		
If the holdover provisions demand an increase in rent payments, is the health system collecting additional rents in accordance with those holdover provisions?		
Does the health system keep an inventory of its real estate portfolio?		
Has the health system established guidelines for entering into time-share leasing arrangements?		

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