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Developing an Office Space Lease Compliance Program

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In today's regulatory climate, hospitals and healthcare systems are beginning to recognize that owning real estate is costly and requires sophisticated management to operate efficiently and in compliance with healthcare regulatory requirements. One of the most important issues affecting healthcare leasing arrangements is whether federal fraud and abuse laws are implicated. The federal government spends trillions of dollars on healthcare programs each year, and it estimates that fraud accounts for up to 10% of those expenditures.[1] In recent years, federal agencies have made prosecuting healthcare fraud a priority. The most commonly prosecuted federal fraud and abuse laws are the Stark Law[2] and the Anti-Kickback Statute (AKS),[3] as well as the False Claims Act.[4] These laws significantly influence leasing arrangements between hospitals and healthcare providers.

In light of the stringent requirements imposed by the Stark Law and the AKS, hospitals and healthcare providers should develop an intercompany compliance program specifically for office space leasing arrangements with potential referral sources. This article is designed to provide an overview of topics that hospitals and health systems should consider when developing such a program.

The Team

The first step in implementing a space lease compliance program is to assemble an experienced team of healthcare compliance and real estate professionals to oversee the project. The team should be led by the provider's compliance counsel and an experienced real estate attorney with healthcare compliance experience. Other team members will include the provider's real estate or facilities department, a real estate appraiser, and an architectural firm or space planner with experience measuring office space. To the extent that the provider does not manage its facilities or real estate holdings, the outside property management

firm with this responsibility should be involved in the process. An experienced team will be able to spot issues and develop best practices based on their experience. For example, an experienced real estate attorney and property manager will be able to spot arrangements that are not commercially reasonable.

When undertaking any compliance project that will involve the use of outside consultants, the provider's legal counsel should insist on each consultant executing a confidentiality agreement. The provider needs assurances that any information discovered through the compliance process is kept strictly confidential. All communications and work product should also run through legal counsel to protect the same under the attorney-client privilege and work product doctrine.

Fraud and Abuse Laws

The foundation of any space lease compliance program should be based on complying with regulations under the Stark Law and the AKS. Over the years, regulators have promulgated regulations under both that apply to space leasing arrangements. Those regulations and the guidance and commentary interpreting those regulations provide invaluable insight for any compliance program.

Space lease compliance programs should assume that all space leasing arrangements will be subject to the Stark Law and AKS. This is primarily due to the fact that the ownership within a corporate entity changes over time, and as a result, a space lease that may not initially be subject to the Stark Law or the AKS could later be subject to one or both of the laws. Therefore, this section does not include an analysis of how to determine if either law applies to the parties involved in a leasing arrangement. Instead, it assumes that all leases are subject to the Stark Law and AKS.

While many of the rules that are applicable to space leasing arrangements are similar under both laws, a high-level summary of both is worthwhile.

The AKS

Under the AKS, space leasing arrangements between regulated parties are prohibited unless the arrangement meets one of the statutes' safe harbors. A commonly used safe harbor for leasing arrangements is the *space rental safe harbor.*[5] It provides that remuneration (kickbacks, bribes, or rebates) does not include any payment made by a tenant to a landlord for the use of premises, so long as the following five conditions are met:

(1) the lease agreement is set out in writing and signed by the parties;

(2) the lease agreement specifies the premises covered by the lease;

(3) if the lease provides access to the premises for periodic intervals of time, rather than on a full-time basis, the lease must precisely specify the schedule of such intervals, including their exact length and rent for such interval;

(4) the term of the lease is for not less than one year;

(5) the aggregate rental charge is set *in advance* and is consistent with *fair market value* (FMV) in arms-length transactions; and

(6) the aggregate space rented does not exceed that which is reasonably necessary to accomplish the commercially reasonable business purpose of the rental.

While all of the conditions within the space rental safe harbor should be followed, those related to the payment of rental should be reviewed carefully. The rental rate must be "set in advance" at the time the lease is executed. This requirement means that the rental rate must be established in the agreement at the commencement of the term, without taking into account the volume or value of any referrals or business otherwise generated between the landlord and tenant.

In addition to the rent being set in advance, it must also be consistent with FMV for the space being leased. For purposes of this statute, the term "fair market value" is defined as the value of the rental property for general commercial purposes, but it should not be adjusted to reflect the additional value that one party (either the prospective landlord or tenant) would attribute to the premises *as a result of its proximity or convenience to referral sources.*[6] The FMV requirement becomes particularly important when analyzing healthcare leasing arrangements under the AKS and the Stark Law. A discussion about establishing fair market rental rates is included below in this article.

The Stark Law

The Stark Law has many similarities to the AKS, in that it targets fraud and abuse in government-run healthcare programs. To the extent that the Stark Law applies to a space leasing transaction, then an exception to the Stark Law must be found prior to entering into the leasing arrangement; otherwise, the arrangement may be in violation of the law and civil penalties may be imposed.

There are a number of Stark Law exceptions, although the *rental of office space* exception applies to most space leasing arrangements.[7] The exception allows payments for the use of office space made by a tenant to a landlord if the leasing arrangement meets the following requirements:

(1) the agreement is in writing, signed by the parties, and specifies the premises;

(2) the space to be rented does not exceed that which is reasonable and necessary for the "legitimate business purposes" of the tenant and is used exclusively by the tenant;

(3) the lease term is at least one year;

(4) the rental charge over the term of the agreement is set in advance and is consistent with FMV;

(5) the rental charge over the term of the agreement is *not* determined in a manner that: (a) takes into account the volume or value of referrals or other business generated between the parties; or (b) uses a formula based on the revenue raised, earned, billed, collected, or otherwise attributable to the services performed or business generated in the premises, or per unit of service rental charges (to the extent that such charges reflect services provided to patients referred by the lessor to the lessee); and

(6) the agreement would be *commercially reasonable* even if no referrals were made between the landlord and tenant.

The Stark Law rental of office space exception is similar to the AKS space rental safe harbor. Additionally, the Stark Law and AKS have similar FMV requirements. The Stark Law rental of office space exception provides that the leasing arrangement must be consistent with arms-length transactions, and the rental amount must be consistent with the general market value for the space. The rental amount *cannot* be adjusted to reflect the additional value that the prospective landlord and tenant would attribute to the proximity or convenience to the other where one party is a potential source of patient referrals to the tenant. The fair market rental rate cannot vary based upon volume or value of referrals.

Any space lease compliance program should be designed to ensure that all space leasing arrangements comply with both the Stark and AKS regulations discussed above.

Tax Considerations

For nonprofit, tax-exempt healthcare organizations, any space lease compliance program should also ensure that any leasing arrangement complies with various tax laws. In particular, nonprofit, tax-exempt entities entering into leasing arrangements with for-profit entities should consider four issues that may ultimately jeopardize their tax-exempt status or a benefit conferred upon the entity based upon its tax-exempt status: (1) whether the leasing arrangement would result in private inurement to the landlord or tenant; (2) whether the leasing arrangement would confer a private benefit to the landlord or tenant; (3) if the leased spaced is financed with tax-exempt bond proceeds; and (4) whether the leasing arrangement will affect a property tax exemption. A discussion of each issue is described below.

Private Inurement

Any space lease compliance plan should attempt to prevent leasing arrangements where private inurement could exist. The concept of private inurement is particularly important for nonprofit, tax-exempt entities. The concept is based on Section 501(c)(3) of the Internal Revenue Code, which states that for an entity to receive and maintain its tax-exempt status, "no part of the net earnings of [the entity] may be to the benefit of *any private shareholder or individual.*" This means that none of the income or assets of an exempt organization may be permitted to directly, or indirectly, unduly benefit a person or other entity that has a close relationship with the organization, when he, she, or it is in a position to exercise a significant degree of control over the exempt entity. The private inurement doctrine was created to ensure that tax-exempt entities further their charitable purpose and not the private interests of the directors, trustees, officers, or other interested persons—otherwise known as "insiders."[8] If a nonprofit entity is found to have violated the private inurement doctrine, its tax-exempt status could be revoked or denied.

With that in mind, any space lease compliance plan should attempt to identify proposed leasing arrangements where a tax-exempt entity is leasing space to or from a person who qualifies as an *insider,* or a for-profit entity in which an insider has an interest. The private inurement doctrine does not necessarily prevent an exempt organization from leasing space to or from an insider if the rent and other terms are reasonable and are consistent with arm's-length transactions. For example, a lease with a fair market rental rate to an insider would most likely avoid a violation of the private inurement doctrine as there would be no apparent indication of either party gaining an excess benefit from the transaction.

Private Benefit

Nonprofit, tax-exempt entities also need to incorporate safeguards into their space lease compliance plans to avoid private benefit. The private benefit doctrine requires that an exempt entity operate exclusively for exempt purposes.[9] Under this doctrine, an exempt organization will not be regarded as operating exclusively for its exempt purpose if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[10] The private benefit doctrine differs from the private inurement doctrine in that it is broader and applies to transactions with individuals or entities *that are not, or do not have members who are, insiders.* It should be noted, however, that the private benefit doctrine tolerates some incidental benefit to private parties as long as that benefit is insubstantial. Tax-exempt entities should be careful to avoid any transaction where private benefit could exist, as the Internal Revenue Service has used the doctrine to deny or revoke organizations' exempt status.[11]

When a tax-exempt organization desires to lease space to or from a for-profit entity, the private benefit doctrine will most likely apply. Therefore, the parties involved must look at whether the agreement provides more than an incidental benefit to the for-profit entity so that the transaction does not jeopardize the exempt entity's exempt status. An exempt organization is designed to operate for charitable purposes, and as a result, the majority of its activities/benefits should be dedicated to its charitable purpose, and the private benefit the lease confers should be insignificant in comparison. The exempt organization should also look at the lease terms to make sure that it is agreeing to what could be considered necessary to effect its exempt purpose and that the terms and the price do not provide any unnecessary benefit to the for-profit party. For example, where a hospital leases space to a for-profit entity for necessary services at FMV, and for as long as those services are needed for the hospital to effect its charitable purposes, the arrangement should not violate the private benefit doctrine.

Private Business Use

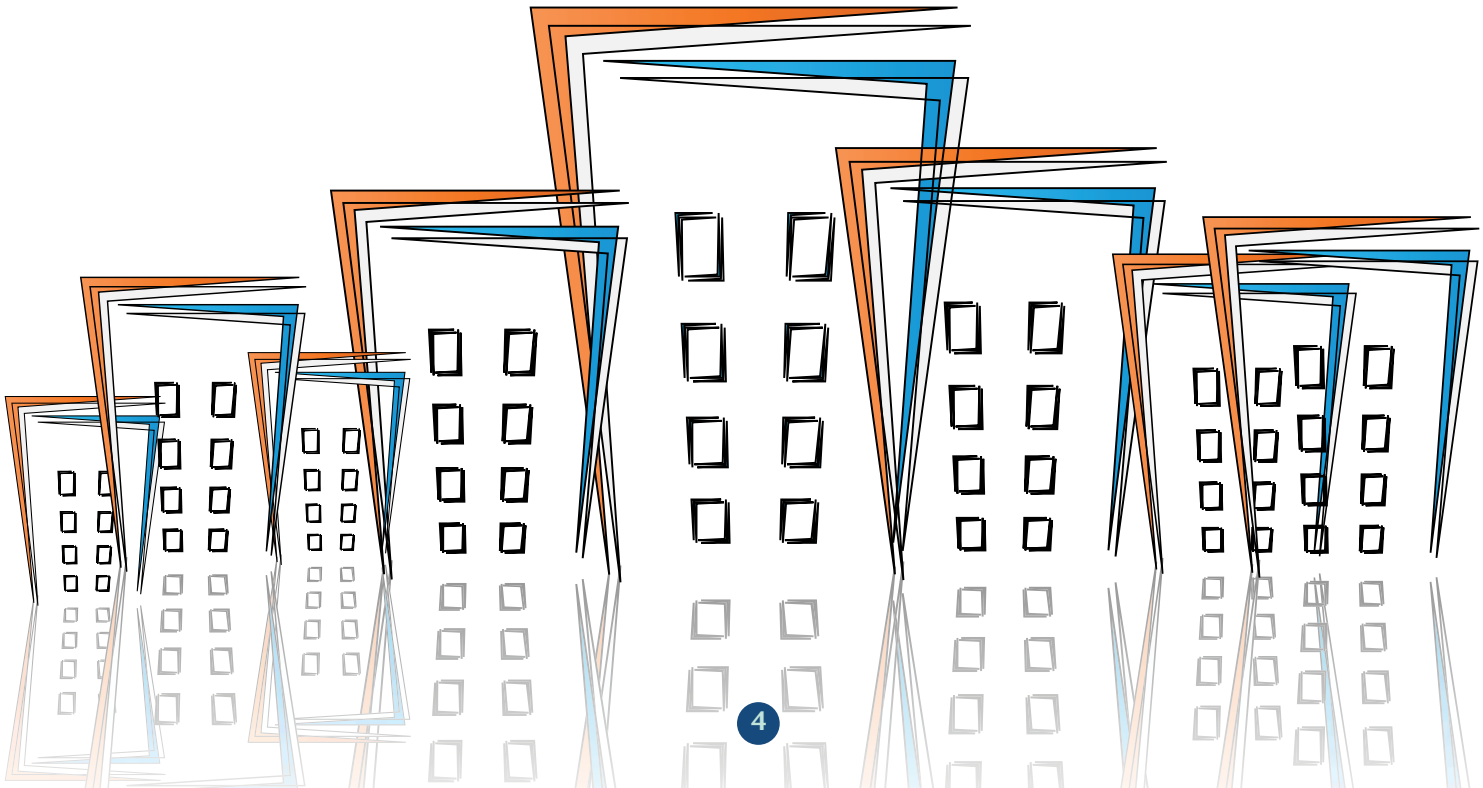
When a tax-exempt organization finances the construction or purchase of a facility using tax-exempt bonds, the facility is subject to certain use restrictions. This is primarily the case because the purchaser of the bonds and the borrower receive certain tax benefits based on the tax-exempt status of the borrower entity. As a condition of receiving preferential tax treatment, the facility financed cannot be used for any "private business use."[12]

Section 1.141-3(b)(3) of the Treasury Regulations provide that the lease of bond-financed property to a private actor (i.e., a non-governmental person for purposes of governmental bonds or use other than by a qualified 501(c)(3) organization engaged in an activity related to its exempt purpose, in the case of Qualified 501(c)(3) bonds) is private business use of the property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. Failure to comply with these federal tax requirements can jeopardize the preferential tax status of the bonds. It should be noted that, in some cases, short-term leasing arrangements to a for-profit user are permitted, although that is the exception rather than the rule.[13]

To the extent that the provider has financed a facility with tax-exempt bonds, the space lease compliance plan should include additional guidelines to address private use concerns.

Property Tax Exemptions

Finally, any space lease compliance program should attempt to identify any property tax exemptions that apply to the space



owned or leased by a provider. In many cases, property tax exemptions have specific ownership and use requirements. If the space is leased to an individual or for-profit entity that fails the ownership or use requirement, the exemption could be denied or revoked. The compliance team that is developing the compliance program should incorporate any property tax exemption requirements into the program.

Inventory Real Estate Holdings

After the team understands the scope and purpose of the compliance plan, it is essential to prepare an inventory of the provider's real estate holdings. The inventory should identify properties that are owned and those that are leased by the provider. For leased properties, the compliance team should audit all existing lease agreements. The scope of the audit should identify the core lease terms, the amount of space leased, the owner of the building, and the make-up of the building owner (e.g., whether or not physicians or healthcare providers hold an ownership interest). The result of the audit should be a summary report or abstract of the lease agreements. That abstract can then be used to identify noncompliant lease arrangements that need to be addressed going forward.

After preparing the audit, the compliance team should identify use restrictions imposed on any buildings regardless of whether or not the buildings are owned or leased by the provider. In some cases, a title search may be necessary to identify restrictive covenants in the chain of title if the provider does not have complete records of the property history. Additionally, the compliance team should determine if any owned properties are subject to tax-exempt bond financing arrangements or any property tax exemptions. As noted above, bond-financed space is generally subject to prohibitions against use by private or for-profit entities. Along the same lines, a property tax exemption is often conditioned upon the space being used for an exempt purpose.

Space Measurements

Once the compliance team has taken an inventory of its real estate holdings, it should undertake a space measurement audit for any property for which the provider is the landlord or tenant. The space measurement audit allows the provider to adequately describe the leased space. Knowing the amount of space leased is important because it is a factor when determining if the amount of rent to be paid under the leasing arrangement is FMV. This is particularly true because fair market rental valuations establish rental rates on a per-square foot basis. It is also important from a business perspective to ensure that the provider is not overpaying in cases when it is the tenant or losing revenue when it is the landlord.

The legal counsel for the compliance team should engage an architect or space planner to assist with measuring all of the provider's real estate holdings. Because measurement methodologies vary, the compliance team should work with the architect or space planner to agree upon a measurement methodology going forward. For purposes of measuring office space, most providers elect to use a measurement standard approved by the Building Owners and Managers Association (BOMA). Providers often prefer BOMA standards because they are often employed by institutional real estate owners and investors, which supports the case that the provider's approach is commercially reasonable.

FMV Opinions

The FMV requirement becomes particularly important when analyzing healthcare leasing arrangements under the Stark Law and AKS. It is also important for nonprofit, tax-exempt organizations to ensure that their rental rates are consistent with FMV when leasing to a for-profit entity as noted above. In most cases, the provider and its staff are not qualified or sufficiently objective to establish fair market rental rates. Therefore, providers are encouraged to engage an experienced real estate appraiser or commercial real estate broker to provide a written opinion of value. While appraisals or opinions of value are not required under the Stark Law or the AKS, an independent valuation will provide evidence that the provider took substantial steps to ensure that it was entering into FMV leasing arrangements.

The selection and engagement of a real estate appraiser or commercial real estate broker should be carefully documented. While commercial real estate brokers often provide valuable opinions, an experienced real estate appraiser is the gold standard. The real estate appraiser should have the Member of the Appraisal Institute designation from the Appraisal Institute together with experience valuing medical office or hospital space, as the case may be, in the community where the subject property is located. If a commercial real estate broker is selected for the project, he or she should have significant experience valuing office space in the community where the subject property is located.

The compliance team should establish criteria for engaging a valuator to provide an opinion of market rental rates. The criteria should include a mandate that in-house or outside counsel always engages the valuator for the benefit of the provider. Engaging the valuator through counsel is designed to protect the communications between legal counsel and the valuator under the attorney-client privilege and any reports issued under the work-product doctrine.

This author prefers to engage valuators through an engagement letter that outlines the scope of work to be performed by the valuator. The engagement letter should include the following:

- The location and type of property to be valued;
- Type of rent rate methodology to be used (e.g., gross versus net);
- Type of building services offered to the tenant;
- The length of the proposed lease terms;
- Tenant improvement allowances offered;
- Definitions of FMV under the Stark Law and the AKS should be used for valuation purposes;

- All communications about the project and the report should be issued to legal counsel;
- The rental rate should be issued in the form of a range of FMV; and
- The report should be issued in draft form.

The opinion of market value should be issued in the form of a range to offer the provider with some flexibility when negotiating rental rates. The valuator should also indicate how the provider should select a rental rate within the range. For example, space with higher-quality finishes may command a higher rental rate. The engagement letter may also specify whether rental rate escalators or tenant improvement allowances are generally offered to tenants in the market.

The provider should always keep in mind that valuators may be called to testify and defend their opinions of value. A qualified and experienced valuator will likely serve as a better witness in a case where fair market rates are challenged.

Approval Process; Disclosure Reporting

The compliance plan should outline the process of negotiating and approving a new space lease. In order to ensure that the technical requirements imposed on leasing arrangements are satisfied, multiple layers of approval are encouraged. While the property management team should assume the responsibility for administering lease agreements, the finance or accounting departments and possibly the chief executive should be involved in approving any new space lease agreements. Involving several departments and requiring each to physically sign off on the proposed arrangement helps to ensure that the compliance requirements are met. It also forces high-level employees to assume ownership for the arrangements.

The property management team and the responsible administrators who will sign off on the arrangement should document the approvals using a contract approval form. The contract approval form should describe the responsible property management employee who is in charge of the arrangement and the administrators that will ultimately approve the arrangement. The contract approval form should force the responsible property management official to confirm the following:

- The terms of the space lease comply with the Stark Law and AKS office space lease exceptions;
- The space being leased has been measured and the square footage is accurately set forth in the space lease;
- The rental rate entered into the space lease is within the range of fair market rates for the space as documented by the provider through valuations;
- The permitted use in the space lease will not jeopardize any property tax exemption and/or tax-exempt bonds allocated to the space; and
- The contracting parties are not excluded from participating in Federal Procurement and Nonprocurement Programs or by the U.S. Department of Health and Human Services Office of Inspector General (OIG).

In addition to developing a hierarchy of approvals before a space lease is executed, the compliance team should also develop a disclosure protocol for potential space lease arrangements that may violate any of the fraud and abuse laws or tax laws contemplated herein. A space lease compliance plan should incorporate a process whereby noncompliant arrangements are identified and reported to compliance counsel and a brief report issued to high-level administrators.

Education

Any compliance plan should incorporate an educational component where members of the compliance team educate staff members involved in property management. The compliance team should educate members of the property management team on fundamental real estate concepts, focusing on different rental rate methodologies, how space is measured, negotiating rental rates, and tenant improvement allowances.

The compliance team should incorporate regulatory guidance and case law as a means of describing noncompliant leasing arrangements. A good starting point is a Special Fraud Alert[14] that OIG issued, describing "questionable" leasing arrangements that the AKS is designed to prohibit:

- Rental amounts in excess of amounts paid for comparable property rented in arms-length transactions between persons not in a position to refer business;
- Rental amounts for subleases that exceed the rental amounts per square foot in the primary lease;
- Rental amounts that are subject to modification more often than annually;
- Rental amounts that vary with the number of patients or referrals;
- Rental arrangements that set a fixed rental fee per hour, but do not fix the number of hours or the schedule of usage in advance (i.e., "as-needed" arrangements);
- Rental amounts that are only paid if there are a certain number of federal healthcare program beneficiaries referred each month; and
- Rental amounts that are conditioned upon the supplier's receipt of payments from a federal healthcare program.

Another practical example comes from *United States ex rel. Goodstein v. McLaren Regional Medical Center,* 202 F. Supp. 2d 671 (E. D. Mich. 2002), where a qui tam action revealed the challenges in determining fair market rental rates.

Annual Compliance Audits

Finally, any compliance plan should incorporate an annual review of existing space lease agreements and leasing practices. The goal is to identify arrangements that may not have been documented

properly or that may be out of compliance due to a change in circumstances. Members of the property management team should also walk existing buildings on a periodic basis to determine how space is being occupied and by whom.

Conclusion

Developing a space lease compliance plan can be complex. This article is designed to serve as a framework for a provider intending to develop a space lease compliance plan, although it is not designed, nor intended, to be comprehensive. Providers are encouraged to enlist the services of experienced healthcare compliance attorneys and real estate attorneys with compliance experience when developing a compliance plan. The more experienced the team, the better the chances are that the provider will avoid costly compliance issues going forward.

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Portions of this article under the headings of Private Benefit and Private Use were previously published by the American Bar Association (ABA) in connection with a speech given by the author titled "Medical Office Leases: Understanding the Regulatory Requirements Behind the Lease Terms" at the ABA Real Property, Trust & Estate Spring Symposia in 2009.

1 Foster, R.S., et al. Updated and Extended National Health Expenditure Projections, 2010-2019, Centers for Medicare & Medicaid Services, June 29, 2009, *available at* www.cms.gov/NationalHealthExpendData/downloads/NHE_Extended_Projections.pdf (last visited September 25, 2012).

2 42 U.S.C.S. § 1395nn.

3 42 U.S.C. § 1320a-7b.

4 31 U.S.C.S. § 3729-3733.

5 42 C.F.R. § 1001.952(b).

6 42 C.F.R. § 1001.952(b)(6) (emphasis added).

7 42 U.S.C. § 1395nn(e)(1)(A).

8 An "insider" is generally considered one who has a unique relationship with the exempt organization where the individual (or corporation) "can cause application of the organization's funds or assets for the private purposes of the person by reason of the" person's position to exercise and control over the organization. Bruce R. Hopkins, The Law of Tax Exempt Organizations, 510 (10th ed. 2011) (citing *American Campaign Academy v. Comm'r,* 92 T.C. 1053 (1989). Insiders may include an organization's founders, trustees, directors, officers, key employees, members of the family of these individuals, and certain entities controlled by them. *Id.*

9 Treas.Reg. §1-501(c)(3)-1(c).

10 *Id.*

11 Bruce R. Hopkins, Nonprofit Law Insights: Beware the Private Benefit Doctrine, *available at* http://newsletterlink.pkfnan.org/pkfnan/article.asp?cid=32&nid=9&pid=341s0145be251e452w4eut2l&aid=375&issue=Fall+2001 (last visited September 25, 2012).

12 26 U.S.C.A § 145(a)(2); 26 U.S.C.A § 141.

13 Treas. Reg. § 1.141-3(d)(3)(i) and (ii).

14 Special Fraud Alert, February 2000 - Rental of Office Space in Physician Offices by Persons or Entities to which Physicians Refer, *available at* https://oig.hhs.gov/fraud/docs/alertsandbulletins/office%20space.htm (last visited October 1, 2012).