OIG Approves Hospital/Physician ASC Joint Venture; Cautions Against Valuing Intangibles

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The Office of Inspector General of the Department of Health & Human Services (“OIG”) issued an advisory opinion on July 22, 2009 (Advisory Opinion 09-09) stating that it would not impose administrative sanctions under the federal anti-kickback laws on a proposed ambulatory surgery center (“ASC”) joint venture between a general acute care hospital (the “Hospital”) and seven orthopedic surgeons (the “Surgeons”), even though the proposed transaction did not fit within the anti-kickback safe harbor for ASC joint ventures. In analyzing the proposed transaction, the OIG borrowed heavily from earlier advisory opinions that approved similar hospital-physician joint ventures, making its conclusion not surprising. However, the opinion provides valuable insight on the OIG’s position (or confusion, some might argue) with regard to valuation techniques used to compensate hospitals and physicians for their contributions to the joint venture. In a footnote in the opinion, the OIG expressed its suspicion of transactions which give credit to either joint venture party for contributing general intangibles to the joint venture.¹

The Proposed Joint Venture

Under the proposed transaction, the Hospital and the physician investors would jointly own, through a limited liability company (the “JV Company”), an ASC with two operating rooms in a medical office building (“MOB”) owned by the Hospital and located on its campus. The Surgeons, through their own limited liability company (the “Surgeon LLC”), previously developed a Medicare-certified ASC in the MOB (the “Surgeon ASC”). In the first step of the transaction, the Hospital would develop a single hospital operating room (“Hospital OR”) adjacent to the Surgeon ASC and would contribute the assets of the Hospital OR to the JV Company. Next, the Surgeon LLC would contribute the Surgeon ASC in return for membership units in the JV Company. Prior to the contributions, appraisals would be conducted to determine the fair market value of the tangible assets of each of the Surgeon ASC and the Hospital OR. If necessary, either the Hospital or the Surgeon LLC would make an additional contribution of cash to equalize the value of their respective contributions. After the contributions, the JV would own and operate the newly combined two-operating room ASC at the MOB (the “JV ASC”). Concurrently with this transaction, the lease for space occupied by the Surgeon ASC would be terminated, and the Hospital (as lessor) and the JV Company (as lessee) would execute a new lease for the combined space.
Application of the Anti-kickback Statute

The federal anti-kickback statute is implicated by joint ventures between hospitals and physicians who refer to them. The statute makes it a criminal offense knowingly and willfully to offer, pay, solicit, or receive any remuneration to induce or reward referrals of items or services reimbursable by a federal health care program.1 The statute has been interpreted to cover any arrangement where one purpose of the remuneration was to obtain money for the referral of services or to induce further referrals. As a result of the statute’s overwhelming breadth, Congress and the OIG created regulatory “safe harbors” to protect certain specified arrangements that might otherwise violate the statute. If each of the specific conditions of the applicable safe harbor is met, the parties involved will not be prosecuted or sanctioned for their participation in the arrangement. The OIG created safe harbors for physician-owned ASCs, as well as a separate safe harbor for ASCs jointly owned by physicians and hospitals.2 The rationale behind the physician/hospital safe harbor is to give hospitals the same opportunities as physicians to develop and invest in ASCs. Without the safe harbor, hospitals could be at a competitive disadvantage when they compete with ASCs owned by physicians, who principally control referrals.

In analyzing the proposed arrangement, the OIG noted that the transaction would not comply with the anti-kickback safe harbor for hospital/physician-owned ASCs for failure to meet three of the eight safe harbor elements, namely: (i) the hospital investor must not be in a position to make or influence referrals, directly or indirectly, to any physician investor or the ASC; (ii) the physician investors must hold their investment interests in an ASC either directly or through a group practice composed entirely of physicians who are qualified to invest directly; and (iii) the amount of payment to an investor in return for the investment must be directly proportional to the amount of capital invested by that investor. As a result, the OIG undertook a determination of whether the transaction nevertheless posed a minimal risk under the anti-kickback statute. After analyzing the proposed arrangement, the OIG concluded that under the circumstances and given the terms of this specific transaction, the risk of fraud and abuse was minimal.

First, the OIG concluded that although the Hospital was in a position to make or influence referrals to the JV ASC and the Surgeon investors, the transaction included certain limits on the Hospital’s ability to direct or influence such referrals. For example, employees of the Hospital would not refer patients to the JV ASC, the Hospital would not require or encourage any members of its medical staff to refer patients to the JV ASC or the Surgeon investors, the Hospital would not track referrals, if any, by its medical staff to the JV ASC or the Surgeon investors, any compensation the Hospital pays to its medical staff would be at fair market value and would not take into account any referrals to the JV ASC or the Surgeon investors, the Hospital would inform its medical staff annually of these matters, and the Hospital would continue to operate its own facilities for outpatient surgery. In light of these safeguards, the OIG found that the ability of the Hospital to direct or influence referrals to the JV ASC or the Surgeon investors was significantly constrained.

Second, the OIG noted that although the Surgeon investors were not investing in the JV Company directly as required by the safe harbor, the use of intermediate investment entities would not cause concern where each Surgeon investor’s ownership in the Surgeon LLC was proportional to his or her capital investment, and the Surgeon investors would receive a return on their investments that would be the same as if they had invested in the JV Company directly. Therefore, the OIG found that the use of a “pass-through” entity would not substantially increase the risk of fraud or abuse.

Third, the OIG was not concerned that potential return on investment by each investor would not necessarily be proportional to the amount of capital invested by such investor (due to the differences
in the amounts originally invested by the parties in the Surgeon ASC and the Hospital OR, respectively). Since the agreed upon value of the parties’ respective capital contributions to the JV Company would include only (i) the appraised value of the tangible assets of the Hospital OR and the Surgeon ASC and (ii) the cash needed to equalize the value of their respective contributions, the OIG concluded that the risk for abuse is low. The OIG rationalized that any differences in return on capital would not be related to the parties’ past or anticipated referrals to the JV ASC.

In a footnote, the OIG said that it might have reached a different conclusion had the parties appraised the values of the Hospital OR and the Surgeon ASC using a cash flow-based valuation, which it argued could compensate the contributing party for the value of their future referrals to the JV ASC. In the OIG’s words,

“Because the Surgeon Investors are referral sources for the Surgeon ASC, a cash flow-based valuation of that business potentially would include the value of the Surgeon Investors’ referrals over the time that their ASC was in existence prior to the merger with the Hospital ASC. The result might be that the Surgeon Investors would receive a greater return on their capital investment than the Hospital, which could reflect the value of their referrals to the Surgeon ASC.”

The OIG retreated from asserting that a cash flow-based valuation or other valuation methods involving intangible assets would necessarily result in a violation of the anti-kickback statute. The existence of a violation, the OIG noted, depends upon all of the facts and circumstances of a particular case.

**Intangible Assets Revisited**

The OIG’s comments underscore a long-standing suspicion of methods of valuation that take into account historic patient volume or financial performance. In previous letters and statements, the OIG has indicated that in the context of acquisitions of physician-owned businesses, any payment in excess of fair market value for the hard assets would be open to question. The OIG’s concern is that the payment for goodwill can potentially represent payment for future referrals, especially in the context where the business purchased continues to rely (at least in part) on referrals from the selling physicians. Consistent with its prior statements, the OIG, in Advisory Opinion 09-09, has cautioned that the use of a cash flow-based valuation may reflect the value of future referrals by the Surgeon investors to the ASC.

The OIG’s view of intangibles in valuations has been criticized as ignoring universally accepted valuation methods. Arguably, by ignoring the value of the goodwill that is attributed to an ongoing business, the business owner or seller is not receiving true fair market value for his or her assets, or at the very least is conveying a windfall to the buyer or other joint venture partner. In the case of the joint venture analyzed in Advisory Opinion 09-09, the Surgeon investors would have likely received considerably more for their contribution of the Surgeon ASC (an ongoing business), had a discounted cash flow analysis been used.

While the OIG has refrained from declaring the use of cash flow-based valuations or goodwill as a per se violation of the anti-kickback statute, Advisory Opinion 09-09 and other OIG letters make clear that the OIG will evaluate each proposed ASC joint venture on the basis of the specific facts of the arrangement. This reinforces the importance of engaging experienced healthcare legal counsel in the
early stages of forming similar joint ventures in order to structure the arrangement in a manner that
minimizes or eliminates the risk of violating the anti-kickback statute.

If you have any questions concerning these developing issues, please do not hesitate to contact any of
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1 Copies of OIG Advisory Opinions, including Advisory Opinion 09-09, can be found on the OIG’s website,
http://oig.hhs.gov/fraud/advisoryopinions.asp.

2 The anti-kickback statute is set forth at section 1128B of the Social Security Act.

3 The hospital/physician safe harbor, set forth at 42 C.F.R. section 1001.952(r)(4), has the following requirements: (i) the terms
on which an investment interest is offered to an investor must not be related to the previous or expected volume of referrals,
services furnished, or the amount of business otherwise generated from that investor to the ASC; (ii) the ASC or any investor
(or other individual or entity acting on behalf of the ASC or any investor) must not loan funds to or guarantee a loan for an
investor if the investor uses any part of such loan to obtain the investment interest; (iii) the amount of payment to an investor
in return for the investment must be directly proportional to the amount of capital investment (including the fair market value of
any pre-operational services rendered) of that investor; (iv) the ASC and any hospital or physician investor must treat patients
receiving medical benefits or assistance under any federal health care program in a nondiscriminatory manner; (v) the ASC may
not use space such as operating and recovery room space, located in or owned by any hospital investor, unless such space is
leased from the hospital in accordance with a lease that complies with the space rental safe harbor, nor may the ASC use
equipment owned by or services provided by the hospital investor unless such equipment is leased in accordance with a lease
that complies with the equipment rental safe harbor, and such services are provided in accordance with a contract that complies
with the personal services and management contracts safe harbor; (vi) all ancillary services for federal health care program
beneficiaries performed at the ASC must be directly and integrally related to primary procedures performed at the ASC, and
none may be separately billed to Medicare or other federal health care programs; (vii) the hospital may not include on its cost
report or any claim for payment from a federal health care program any costs associated with the ASC (unless such costs are
required to be included by a federal health care program); and (viii) the hospital may not be in a position to make or influence
referrals directly or indirectly to any investor or the ASC.

4 See, for example, Letter from D. McCarty Thornton, Acting Associate General Counsel, Inspector General Division, Office of
the General Counsel, U.S. Department of Health & Human Services, to T.J. Sullivan, Technical Assistant (Health Care Industries),
Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service (December 22,
1992) (cautioning against payments for goodwill, value of ongoing business unit, covenants not to compete, exclusive dealing
agreements, patient lists or patient records where there is a continuing relationship between the buyer and the seller and the
buyer relies on referrals from the seller). See also, Letter from D. McCarty Thornton, Acting Associate General Counsel,
Inspector General Division, Office of the General Counsel, U.S. Department of Health & Human Services, to Harvey A.
Yampolsky, Arent, Fox, Kintner, Plotkin & Kahn (November 2, 1993) (“Anytime an entity is acquiring a lab where the entity is in
a position to benefit from referrals from the physician(s) selling the lab, there is always a question that a portion of the amount
paid for the lab is attributable to future referrals.”).