



SEPTEMBER 2009

EXECUTIVE SUMMARY

**IN-HOUSE COUNSEL,
BUSINESS LAW AND GOVERNANCE,
AND TAX AND FINANCE
PRACTICE GROUPS**

The Physician Compensation Committee: An Idea Whose Time Has Come

**Michael Peregrine, Esquire
Ralph DeJong, Esquire
Daniel Melvin, Esquire**
McDermott Will & Emery LLP
Chicago, IL

Establishing a standing board-level physician compensation committee is the “smart play” for integration, compliance, and governance reasons. This is particularly the case given recent high-profile Stark Law settlements involving employed physician compensation arrangements. As such, its formation should be aggressively recommended by corporate counsel.

Historically, there has been some reluctance to extend board oversight to physician compensation arrangements, as if that were purely an operational matter reserved exclusively for management guidance and direction. Recently, however, a series of important developments have combined to warrant reconsideration of that perspective. First is the accelerated return to integrated delivery system models, involving a substantial increase in employed physician arrangements. Second is the dramatic increase in regulatory scrutiny of hospital/physician compensation arrangements. Third is the recognition that, to be effective, health system governance must exercise greater oversight of significant business strategies of the organization.

This article will review how these three factors contribute to the consideration of a board-level physician compensation committee, and how such a committee should be structured and operated.

Contributing Factors

Rise in Physician Employment

A major reason arguing for a board-level physician compensation committee is the notable increase in integration arrangements. Recent years have witnessed a renewed commitment to use of the employment model as a health system physician strategy. This reflects a combination of economic and regulatory factors that makes employment more attractive for both physicians and health systems.¹

Increased Regulatory Enforcement Initiatives

A second major reason arguing for a board-level compensation committee is the aggressive regulatory focus on hospital/physician compensation arrangements, from both fraud (e.g., Stark and False Claims Act) and tax (e.g., Internal Revenue Service (IRS) intermediate sanctions) perspectives. The key consideration is the commercial reasonableness of the compensation (or, in other words, the implication of unreasonable compensation).

Stark Law and False Claims Act Considerations

Paying an employed physician above-market compensation potentially exposes a hospital employer to substantial liability under the federal physician self-referral or Stark Law, and the federal civil False Claims Act. Stark violations are a favorite of whistleblower plaintiffs eligible for a bounty under the federal civil False Claims Act, because Stark violations support allegations that the hospitals' Medicare claims are false and fraudulent.²

¹ See, AHA Hospital Statistics © 2000, 2003, 2008 Health Forum LLC, an affiliate of the American Hospital Association; Beith and Strode, "Something Old is Something New Again: Structuring Physician Practice Acquisitions," *Healthcare Financial Management*, July 2009.

² The federal anti-kickback statute's employment compensation exception/safe harbor does not explicitly cap compensation at fair market value and has been interpreted very broadly by the OIG. Because the applicability of the federal anti-kickback law to above-market physician employment compensation is so uncertain, we have not included a discussion of the anti-kickback statute in this article. However, please note that there is an argument that compensation to a physician employee that is in excess of fair market value is not protected by the employment exception/safe harbor.

Last year, Memorial Health in Savannah, GA, paid \$5.08 million to the federal government to settle allegations that the health system paid above-market compensation to employed ophthalmologists in violation of the Stark Law. Filing suit under the civil False Claims Act, the whistleblower in that case collected almost \$900,000, alleging that the Stark violations tainted the hospital's claims to the Medicare program. There is also potential liability for paying a physician-employee compensation that takes into account the volume or the value of the physician's referrals to the hospital-employer. A Tenet hospital paid \$22 million a few years ago to settle allegations of Stark Law violations, including an allegation that physicians' salaries reflected the hospital manager's consideration of the value of the employed physicians' lab referrals to the hospital. Potential False Claims Act liability for health systems is magnified by the sheer number of physicians many systems employ. Overpaying a single physician is one thing, but overpaying a dozen or several dozen employed physicians can easily create the risk of seven-figure liability to the federal government.

Tax-Exempt Status Considerations

Commercially unreasonable physician compensation arrangements also implicate the federal tax-exemption rules, including the intermediate sanctions rules (which can result in excise taxes and disgorgement of excess compensation) and the prohibition against private inurement and excess private benefit (which can result in loss of tax-exempt status). The intermediate sanctions rules apply to compensation arrangements with "disqualified persons," which can include employed physicians, particularly those who are highly compensated or are in leadership positions. If the IRS were to review the compensation of an employed physician and have concerns as to unreasonable levels of compensation, it is likely that the IRS would use the ambiguity in the definition of a "disqualified person" to assert that the allegedly overpaid physician is a disqualified person and that the intermediate sanctions rules apply.

Note: The Covenant Settlement

The most recent example of the government's enforcement focus on physician compensation is the August 25, 2009, agreement by which Covenant Medical Center of

Waterloo, IA, agreed to pay the United States \$4.5 million to settle Stark Law-based allegations arising from Covenant's financial relationships with five physicians. The Department of Justice (DOJ) alleged that Covenant violated Stark "by paying commercially unreasonable compensation *far above fair market value*" [emphasis added] to five employed physicians who referred their patients to Covenant for treatment.³ DOJ's press release claimed that the five physicians "were among the highest paid hospital employed physicians not just in Iowa, but in the entire United States."⁴ However, in its press release, the institution claimed that there was no determination of excess compensation, and that the compensation reflected extremely high levels of productivity.⁵

DOJ and the Office of the Inspector General (OIG) can be expected to pursue aggressively similar types of hospital/physician arrangements suggestive of commercially unreasonable compensation.

Board Oversight Obligations

The third major reason arguing for a board-level compensation committee is increasing regulatory and public policy emphasis on the board's compliance oversight obligations. These obligations—to implement and maintain an "effective" compliance plan—are not static, but are constantly evolving.⁶ The clear expectation is that the board, in consultation with executive staff, will be responsive to major legislative and regulatory developments and direct that the compliance plan be modified to reflect such developments. A current example of such a modification is compliance plan changes to respond to the 2009 amendments to the federal False Claims Act. A related expectation is that the board will require closer compliance plan monitoring of hospital operations subject to specific regulatory enforcement initiatives.

³ See www.usdoj.gov/opa/pr/2009/August/09-civ-849.html.

⁴ See www.usdoj.gov/usao/ian/press/August_09/8_25_09_Covenant.html.

⁵ See www.wfcourier.com/articles/2009/08/25/news/breaking_news/doc4a94156271f78380125347.txt.

⁶ See, e.g., Michael Peregrine, "New Compliance Plan Oversight Developments," American Health Lawyers Association, Business Law and Governance Practice Group Executive Summary (September 2009).

As noted above, employed physician compensation traditionally has been, in most health systems, the exclusive province of executive management. While the board may be called upon to approve significant physician integration investments (typically involving the use of the organization's assets to enter into joint venture arrangements with physicians or to acquire physician practices), the board is rarely involved in the establishment of individual physician compensation—whether for clinical production, administrative leadership positions, or both.

Further, in many health systems, the lines of authority over physician pay can be hazy, leading to confusion over who reviews and approves physician compensations. There is also the very real risk from entrepreneurial, aggressive managers who establish unsupervised and unapproved compensation arrangements with all sorts of physicians. In addition, the support for physician compensation arrangements can be difficult to determine in contrast to those of employed executives.

For these and other similar reasons, it is incumbent on the board to assure its ongoing oversight of internal controls intended to support the fair market value of physician compensation arrangements. The Covenant settlement provides a clear warning of the legal exposure associated with ineffective compensation controls. The regulatory risks to the organization are now simply too high for the board not to become more directly involved. The establishment of a standing board-level physician compensation committee is one of the best ways to accomplish that goal.

The Physician Compensation Committee

The issues, risks, and challenges described above can be prudently and meaningfully addressed by the establishment of a physician compensation committee incorporating the following criteria, among others:

1. Status—A standing committee of the governing board, similar in scope and function to the board's executive compensation committee.
2. Composition—The committee should consist solely of board members who qualify as "disinterested" under the intermediate sanctions three-part rebuttable

presumption of reasonableness safe harbor. Given the variety of legal rules and risks implicated by physician compensation arrangements or other transactions with physicians, the general counsel should be invited to all committee meetings.

3. Advisors—The committee should be authorized to engage its own independent compensation consultants and outside legal advisors, and these professional advisors should report primarily and directly to the committee. The consultant may be the same consulting firm that advises the organization's executive compensation committee, but each compensation committee should be aware of the potentially dual role and should have the ability to proscribe services for the other committee.
4. Core Duty—Responsible for the oversight of all physician compensation arrangements and establishing controls intended to support the fair market value of all such arrangements:
 - The committee would be familiar with all the physician compensation arrangements that exist within the organization.
 - The committee would itself only directly review and approve individual physician compensation arrangements that are deemed higher risk in nature, e.g.:
 - Initial compensation of physicians for whom practice/business is being acquired in a transaction;
 - Total compensation to physicians serving in executive positions;
 - Medical directorships;
 - Compensation for clinical productivity if that compensation exceeds a certain level or percentile of the market data;

- Compensation arrangements that can be reviewed and approved in concept (e.g., “pay-for-call coverage,” or physician review arrangements);
 - Physician compensation methodologies for any employed physician groups (particularly key admitters); and
 - Gifts, relationships with vendors, and other “off books” arrangements that need corporate polices and oversight.
- The committee would structure its review and approval process in a manner designed to assure satisfaction of the “rebuttable presumption of reasonableness” for physicians who may be “disqualified persons” for intermediate sanctions tax purposes.

Concluding Thoughts

The establishment of a standing board-level physician compensation committee is a prudent corporate governance measure, given the potential compliance issues arising from increased hospital/physician integration.

The Physician Compensation Committee: An Idea Whose Time Has Come © 2009 is published by the American Health Lawyers Association. All rights reserved. No part of this publication may be reproduced in any form except by prior written permission from the publisher. Printed in the United States of America.

Any views or advice offered in this publication are those of its authors and should not be construed as the position of the American Health Lawyers Association.

“This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought”—*from a declaration of the American Bar Association*