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Valuing Non-Competes: The *Bradford* Decision

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In an opinion substantively addressing the Stark law and Anti-Kickback statute, a federal court issued summary judgment against a hospital, a physician practice and its physician owners finding that an equipment subleasing arrangement, and related non-compete agreement, improperly assigned value to the volume of "anticipated referrals" in violation of the Stark law. In United States ex rel. Singh v. Bradford Regional Medical Center, Civ. No. 04-186, 2010 U.S. LEXIS 119355 (W.D. Pa. Nov. 10, 2010), the United States District Court for the Western District of Pennsylvania was asked to evaluate claims brought against Bradford Regional Medical Center (BRMC), V&S Medical Associates, LLC (V&S) and its physician owners, Drs. Vaccaro and Saleh (the Physicians), pursuant to a qui tam action alleging that the defendants submitted, or caused to be submitted, false claims to the Medicare program arising out of referrals from Drs. Vaccaro and Saleh to BRMC. At the heart of the dispute was whether the payments under the sublease arrangement, which included substantial amounts attributable to a non-compete agreement, reflected fair market value. The relators alleged that a sublease agreement for a nuclear camera between BRMC and V&S was intended to gain patient referrals for BRMC in violation of the Stark law and Anti-Kickback statute. The government did not intervene in the action.

The defendant, BRMC, owned and operated a small community hospital at which the Physicians were on the medical staff. Prior to 2001, the Physicians were a significant source of referrals to BRMC for inpatient and outpatient hospital services, as well as for diagnostic imaging services provided on the hospital's nuclear camera. Nevertheless, in June 2001, finding that they had enough nuclear medicine patients to support their own machine, the Physicians executed a lease to acquire their own nuclear camera from GE through their medical practice. Faced with declining referrals for nuclear imaging, BRMC executed a sublease agreement effective October 1, 2003 with V&S, pursuant to which BRMC was to sublease the nuclear camera from V&S and use it to provide diagnostic tests for BRMC patients.

V&S, in turn, agreed not to compete with BRMC with respect to the provision of nuclear cardiology services by BRMC for the term of the sublease agreement.

Prior to entering into the sublease, BRMC engaged an accountant to perform a "fair market value" assessment of the arrangement. The accountant found that the arrangement, which called for BRMC to pay $6,545 per month for lease of the camera (the amount V&S paid under the master lease), along with $23,655 per month for all other rights under the sublease, including the covenant not to compete, represented fair market value. Although the sublease stated that the camera would be delivered to BRMC, the camera remained in V&S's offices and BRMC paid V&S $2,500 per month in rent, as well as a billing fee of 10 percent of all collections for tests performed on the camera. In 2004, when the parties decided to upgrade the equipment, V&S executed a new master lease with a new vendor, which included a $200,000 buyout of the old lease with a different vendor. BRMC executed a guaranty of V&S obligations under the lease and buyout, in addition to paying approximately $2,300 per month for the vendor's service agreement. The new camera was located at BRMC.

In a rather lengthy analysis, the court concluded that the Stark law applies to the relationship, finding that the equipment sublease and associated financial arrangements created both direct and indirect financial relationships between BRMC and Drs. Vaccaro and Saleh that did not fall within an exception. In addition, the court found that a general issue of material fact existed as to whether the parties acted with the requisite intent for violations of the Anti-Kickback statute and federal False Claims Act, matters to be addressed at trial.

A substantial portion of the court's analysis was dedicated to analyzing whether the compensation paid by BRMC to V&S under the sublease arrangement varied with, or otherwise took into account, the volume or value of referrals from the Physicians to BRMC. The defendants argued that, under the Stark law, no indirect financial relationship was created between the physicians and BRMC because the payments between BRMC and V&S were flat amounts that did not fluctuate based on referrals from the Physicians, such payments reflected fair market value, and the compensation arrangement resulted in a sensible, prudent business

relationship. By contrast, the relators asserted that the aggregate compensation received by the Physicians reflected the volume or value of referrals to BRMC because the value of the non-compete agreement took into account anticipated referrals from the Physicians.

Despite finding that there was nothing in the sublease agreement, including the associated non-compete provision, requiring the Physicians to refer to BRMC, and further despite the existence of valuation opinions finding that the sublease and accompanying non-compete agreements reflected fair market value, the court concluded that the compensation received by V&S and the Physicians was not fair market value and was determined in a manner that "takes into account the volume and value of referrals."

In reaching its conclusion, the court agreed with the relators that the consideration of "anticipated referrals" is a proper basis for finding that compensation takes into account the value or volume of referrals. Applying this principle to the defendants, the court found that the valuation report prepared by BRMC's accountant prior to the transaction, which compared BRMC's expected revenues with the non-compete in place with the amounts that BRMC would pay under the non-compete agreement, directly "took into account" anticipated referrals to BRMC. The court also relied on other statements of the defendants indicating that the valuation was based on "expected revenues based on the assumption that the [Physicians] would likely refer business to BRMC."

The court rejected BRMC's argument that the Phase I regulations to the Stark law created a "bright line" rule for determining whether compensation takes into account referrals that the defendants satisfied. The bright line rule, according to BRMC, states that a compensation arrangement does not take into account the volume or value of referrals "if the compensation is fixed in advance and will result in fair market value, and the compensation does not vary over the term of the arrangement in any manner that takes into account referrals or other business generated." 66 Fed. Reg. 856, 877-78 (Jan. 4, 2001). Nevertheless, the court held that the defendants had the burden of demonstrating that the fixed compensation is consistent with fair market value and the defendants failed to meet that burden.

The court was not persuaded by the defendants' wholesale reliance on their expert's report as showing fair market value and noted that the defendants never offered any specific explanations or interpretations from the expert's report in support of their position that the compensation arrangements were fair market value. In addition, even though the court agreed that the non-compete agreement was the product of back and forth negotiation between the parties, and did not require the Physicians to refer to BRMC, the record demonstrated that the parties took into account the anticipated referrals by the Physicians as part of the negotiations. The court concluded that the compensation agreement was "inflated to compensate for the [doctors] ability to generate other revenues" and, accordingly, did not reflect "fair market value" under the Stark law.

Ober|Kaler's Comments

The Bradford decision underscores the importance of the valuation of non-competes and other intangible assets when entering into financial arrangements with physicians. If limited to its facts, the case is fairly unremarkable because the valuation at issue quite clearly took into account the volume or value of anticipated referrals to BRMC as a result of V&S shutting down its in-office nuclear camera and referring those patients to BRMC. Whether the reasoning set forth in the opinion will be extended beyond these facts remains to be seen. It seems likely that, given the dearth of case law addressing the Stark law, courts in other jurisdictions will look to this opinion for guidance when evaluating other arrangements assessing value to a non-compete or other intangible assets.