Physician Practice Acquisitions: *Key Legal Concerns for Hospital Boards and Executives*

BY *BARTON C. WALKER, KRISTIAN A. WERLING, & ANNA M. TIMMERMAN, MCGUIREWOODS, LLP*

Last year's enactment of the Patient Protection and Affordable Care Act (PPACA) immediately accelerated the trend toward more highly integrated models of patient care. The trend has grown even more pronounced in the area of physician practices.

HOSPITALS ACROSS THE COUNtry have been acquiring physician practices at a prodigious rate over the past year in the hopes of achieving greater clinical integration and more closely aligning the interests of referral networks to the strategic goals of the hospital. This article describes key legal concerns and some practical considerations in acquiring physician practices.

Factors Driving Physician Practice Acquisition

Several factors are driving the recent increase in physician practice acquisitions. First, reimbursement rates continue to decline in certain specialties, which is having an impact on overall physician compensation. Many physicians hope that by selling their practices to a hospital or health system that they will have more clout in negotiating payer contracts with favorable rates, thus, halting or reversing the trend of declining reimbursement rates. There is also more certainty in drawing a salary as a hospital-employed physician than in private practice.

> Physician practices can more easily measure and report quality and efficiency with electronic medical records, but compliance and installation costs pose significant expenses for physician practices.

Second, healthcare reform is requiring physicians and hospitals to measure and report quality and efficiency. This is a task not easily accomplished by a small- or medium-sized physician practice. Typically a more sophisticated system of tracking costs and patient outcomes is necessary to monitor quality and efficiency benchmarks. Physician practices can more easily measure and report quality and efficiency with electronic medical records, but compliance and installation costs pose significant expenses for physician practices. These costs can be spread over a much larger organization if the practice is part of a hospital or health system.

Third, legislation (as well as changes to the Medicare and Medicaid reimbursement system) is pushing providers toward bundled payments and integrated payments (e.g., in accountable care organizations and Medicare quality and efficiency demonstration programs).

Lastly, a significant factor driving some practice sales is physician practice demographics. Physicians in a practice who are near retirement are more likely to desire to sell their practices. In addition, some younger physicians are also seeking a better work–life balance, which they view as a more realistic possibility as a hospital employee than in private practice.

For all of these reasons, the typical purchaser in most of the current physician practice acquisitions is a hospital or health system; however, a growing number of practices are also merging and acquiring smaller practices for many of the same reasons.

Key Areas of Legal Concern

A handful of legal issues drive the overall transaction structure and need to be considered when acquiring a physician practice.

Stark law. The federal physician self-referral law or the "Stark law" generally prohibits physician referrals for certain "designated health services" if there is a financial relationship between the physician and the entity to which the referral is made. Designated health services include, for example, clinical lab services, radiology and imaging services, physical therapy, durable medical equipment, and inpatient and outpatient hospital services. Typically, physicians in practices that are being acquired make referrals to the hospital that is acquiring them. Because the Stark law is a strict liability statute, entities and physicians must comply with an exception to ensure that the transaction is not illegal.

Most physician practice acquisitions by hospitals are structured to meet the "isolated transaction exception."[1] The isolated transaction exception contains a number of requirements, but perhaps the most important is that the consideration paid must be consistent with fair market value. This is a common theme when structuring physician–hospital transactions. The isolated transaction exception also requires that a) the agreement be in writing signed by the parties, b) no other transactions take place between the parties for six months, c) the consideration paid must not be related to the volume or value of referrals, and d) the transaction must be commercially reasonable, even if no referrals were being made between the parties. In addition to meeting the isolated transaction exception, the post-closing employment of physicians must be structured to meet the employment exception.

> By ensuring that all compensation paid is consistent with fair market value, the hospital can avoid excess private benefit and private inurement challenges.

Anti-kickback statute. The federal anti-kickback statute prohibits the exchange of remuneration with the intent to induce referrals of patients for Medicare or Medicaid services. Note that violation of this statute requires "intent." In the physician practice acquisition context, it is important to clarify in communications between the parties and in the final transaction documents that the intent of acquiring the practice is not to induce referrals. If the parties can demonstrate that the consideration paid in the transaction is consistent with fair market value, then it will be much easier for the parties to defend the position that no remuneration was paid in exchange for or to induce referrals. Although a safe harbor exists

continued on page 12

1 42 CFR § 411.357(f).

Physician Practice Acquisitions...

continued from page 4

for certain practice acquisitions by hospitals, it typically can only apply in the context of retiring physicians.

Tax considerations. The primary tax concern for a tax-exempt hospital purchaser should be to protect the hospital's own tax-exempt status. Fortunately, this is relatively straightforward. As an ancillary matter, tax-exempt hospitals also generally try to ensure that any type of income from physician practices is tax-exempt and is not deemed to be unrelated business income. This is another area in which fair market value is key when structuring the acquisition and post-closing physician compensation. By ensuring that all compensation paid is consistent with fair market value, the hospital can avoid excess private benefit and private inurement challenges. These problems can result in intermediate sanctions from the IRS. Intermediate sanctions are penalties the IRS can impose when certain persons related to a not-for-profit organization receive an excess benefit from that organization.

Deep due diligence can frequently uncover significant hurdles to closing a transaction, such as unknown malpractice liabilities or contractual commitments.

Boards can take steps to create a rebuttable presumption that a transaction is not an excess benefit transaction.[2] First, an authorized body, like the board, must approve the transaction. Second, the authorized body must have appropriate data to ascertain whether the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value. Finally, the authorized body's decision must be adequately documented. Documentation should include the terms of the transaction; the date it was approved; the members of the authorized body who were present during the debate; those members who voted on it; the comparability data obtained and relied upon; how the data was obtained; and any actions taken in consideration of the transaction by a member of the authorized body who has a conflict of interest with respect to the transaction.

Practical Considerations

In addition to the legal and regulatory considerations associated with physician practice acquisitions, there are a variety of practical concerns that hospital boards and senior management should address.

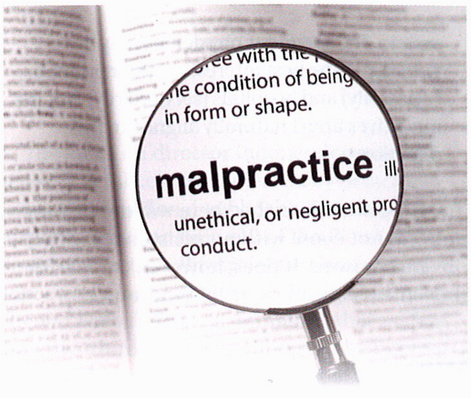
Establish fair market value. As discussed previously, the key to complying with many governing statutes and regulations, as well as to ensure fiscal responsibility, is to establish fair market value relationships with employed physicians. Most hospitals already have a compensation committee and well-defined processes in place to ensure that fair market value compensation is paid. In addition to this process, when a hospital acquires a physician practice and employs the physicians, the board and management should strongly consider obtaining independent fair market value assessments for both the purchase price paid for the physician practice assets and the ongoing compensation paid to the physician employees.

Carefully conduct due diligence. It is important that the board and management institute a rigorous process of conducting due diligence on physician practice targets. This due diligence should not solely be focused on legal and regulatory issues but should also focus on quality and reputational elements of the physician practice. Deep due diligence can frequently uncover significant hurdles to closing a transaction, such as unknown malpractice liabilities or contractual commitments. The transaction team will need to create a plan to overcome these commitments and potential liabilities.

Prepare for non-physician employees. If a physician practice is acquired, it does not only mean that the physician employees of the practice will be transitioned to the hospital. Management and the board must create a plan to employ nurses, allied health professionals, and ancillary personnel from the acquired practice. This will include determining how to successfully transition retirement and health benefits and other lifestyle and ancillary issues that are important to the physician practice's employees.

Be aware of the full cost of the transaction. A physician practice acquisition may have a variety of "hidden" costs for a hospital beyond simply the purchase price paid for the practice's assets. These can include increased malpractice insurance premiums, obligations for new leases on office space for the physicians, and expenses related to expanding electronic medical records and other IT systems. It is important that management and the board understand the full investment costs involved in bringing on the physicians.

Consider physician leadership and governance structure changes. For hospitals that are just starting to build an employed physician base, it is vital that they consider the structure of their physician leadership and governance. Independent physicians likely had significant control over governance in



their private practices and will expect some level of control and input on their subsequent practices, even after becoming employees of the hospital or health system. Advanced consideration of the hospital's approach regarding governance, leadership, and the inclusion of physicians in decision making that impact their practices will be vital to success following closing of the acquisition transaction.

It is important that management and the board understand the full investment costs involved in bringing on the physicians.

As the physician practice acquisition trend accelerates, it is of critical importance that senior management of hospitals and health systems understand the key business and legal issues underpinning the overall structure of these transactions. Equally important is for hospital boards to understand these issues as they impact the organization's overall strategic objectives. Particular attention should be paid to certain key concerns, such as fair market value, as they play out over a series of successive transactions or over the organization as a whole, especially if it is a multi-hospital entity. Close collaboration among business, tax, legal, and finance personnel can help ensure that all of these issues are addressed early in the acquisition process.

The Governance Institute thanks Barton C. Walker, associate, Kristian A. Werling, partner, and Anna M. Timmerman, associate, of McGuireWoods, LLP for contributing this article. They can be reached at bwalker@mcguirewoods.com, kwerling@mcguirewoods.com, and atimmerman@mcguirewoods.com.

2 26 CFR § 53.4958-6(c).