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STRATEGIC PLANNING

Establishing Principles for Hospital-Physician Joint Ventures

By James Lifton and L. Edward Bryant Jr.

When properly structured, joint ventures can increase access to capital as well as clinical and management resources, while offering financial incentives for investors. Improperly structured, however, they can lead to poor financial results, hard feelings between participants, and disrepute in the community. Regulatory and legal problems can even arise, since Medicare has declared certain hospital-physician relationships unlawful.

Typical Joint Ventures

Hospital joint ventures with physicians typically involve procedures that generate a technical, or facility use, fee from Medicare and other payers. Ambulatory surgery centers, endoscopy suites, and imaging centers are common examples.

In the face of reduced professional fees, physicians may seek to maintain their income through facility ownership, which generates a facility fee. Hospitals may decide to participate in such joint ventures, even though they reduce hospital revenue, on the rationale that “half is better than none”—assuming that the physicians would find another partner or move ahead alone if the hospital was unwilling to participate.

The hospital may also be able to set conditions on its partnership with physicians—e.g., resolving concerns about “cherry-picking,” a business practice where physicians refer paying patients to the joint venture and send low-pay or uninsured patients to the hospital or wholly owned hospital facility.

A typical joint venture is structured as a limited liability company (LLC). Under this nontaxable structure, income passes directly through to the owners, which benefits both physicians and hospitals. For taxable owners, such as physicians, the income is not subject to “double taxation” (where earnings are taxable both to the corporation and to the individual investor). And for a nonprofit entity, such as a hospital, being a partner in an LLC strengthens its financial status because its share of the income is tax exempt.

The Board’s Role in Joint Ventures

Board involvement and support for a joint venture is important because of the high stakes involved. Moreover, because a joint venture typically involves the creation of a new legal entity, board approval is required. With hospitals and physicians as co-investors in a joint venture, the hospital will have more at risk than its capital investment; if the venture does not work out, it may also be jeopardizing the hard-won good will of key physicians.

A board-adopted policy, along with a set of principles to guide hospital participation, can help maximize the benefits of joint ventures while minimizing the associated risks.

A Mind-set for Joint Ventures

To create the right mind-set for determining joint venture principles, think about the implications in practical terms.

Assume that the transaction and resulting joint venture will:

- Be entered into for profit. Certainly the expectations of physician investors will be to realize a profit. However, not all enterprises in health care can be profitable. Keep in mind that no investment vehicle will make a bad business venture into a good one. Is the business fundamentally sound? Are the forecasted financial results realistic?

- Be subject to public scrutiny. Would it embarrass the organization if the press, government or non-investing physicians were to learn details of the joint venture? Worse yet, would it put the organization in legal jeopardy?

- Have to be unwound. Investors may need to exit the deal, and defining the exit terms in advance makes this easier for everyone concerned. Keep in mind that, in most instances, the hospital will not be able to bail out the physician investors.

- Set a precedent for other deals. Ask yourself: “Would we do the next joint venture the same way we did this one?” If the answer is *no*, then it’s probably best not to do it that way the first time.

Some Issues to Consider

The following issues and questions point out principles that typically need to be investigated regarding joint venture structures and participation:

1. **Business activity.** Is the proposed business one that, by law, can be owned by a hospital and physicians who refer their patients to it? For instance, will it “practice medicine” or is it a “designated health service” under the Stark Law?

2. **Scope of businesses.** Can the parties define the businesses in which they are willing to invest, and those they are not? Will the hospital put existing, wholly owned services into a joint venture? If so, under what circumstances?

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3. Ownership. Will the hospital accept less than 51 percent ownership? If so, under what circumstances? Will the hospital's ownership stakes render income from the joint venture taxable to the hospital?

4. Control. Will control reflect the ownership percentages? Will the venture have a board or will the owners control it directly?

5. Investors. Will there be any restrictions on investors? For instance, if a group of orthopedic surgeons proposes to enter into a joint venture with the hospital, will the hospital require that the opportunity be open to all orthopedists on the medical staff at the time? What about orthopedists who subsequently join the staff? Will for-profit firms, such as a management company, be allowed as investors?

6. Reserved powers/guarantees. Over what must the hospital reserve powers? (A Catholic hospital, for instance, would have to ensure compliance with the Ethical and Religious Directives for Catholic Health Care Services.) Will the hospital require, and be willing to enter into noncompetition agreements prohibiting the parties from investing in other, competing ventures? Will physicians need to be given control over clinical standards?

7. Payment and free care. What will the joint venture's policy be regarding patients who cannot afford to pay for services? Will the joint venture be required to accept Medicare and Medicaid patients? Concerns about "cherry-picking" can be addressed by establishing a charity care policy for all hospital joint ventures.

8. Valuations. Are participants willing to deal with each other on an "arm's length" basis, that is, using objective third-party valuations of assets going into the deal and unwinding it? Although this arrangement adds expense, it also protects all parties under both the Medicare laws and Internal Revenue Code.

9. Unwind provisions. All businesses with two or more owners need unwind provisions written into the organizational documents. Have the parties considered what might require the deal to be unwound and how each scenario would be addressed? Are these various situations fully addressed in the organizational documents?

10. Structuring the joint venture. Are there alternatives to a joint venture? A joint venture should be viewed as a "means"—the best means—not an "end." There are many ways to share rewards, but true joint ventures require sharing risks as well.

Getting Started

As with many challenges facing health care leadership, commitment and common sense are good places to start:

- Commit to developing (or reviewing) the organization's policy on joint venture participation.
- Identify a working group that can consider the issues listed above.
- Consider the hospital's circumstances and, perhaps, its past experience.
- Develop a standard policy format for the organization.

Legal counsel and the hospital's business advisors can provide feedback on the policy draft, offer input on additional issues to consider and ensure that the policy works from legal and business perspectives. The resulting joint venture policy and principles will support timely, informed, consistent and fair joint ventures, as well as legal and regulatory compliance. **T**

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