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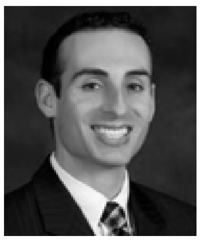
Hospital Acquisitions of Physician Practices: Practical Tips for Both Parties



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Introduction

Throughout the United States, hospitals and physicians are engaging in various affiliation models in order to adapt to the changes resulting from health care reform. While these affiliations take many different shapes and sizes, one of the most popular structures is the acquisition of a physician practice by a hospital. This article identifies several practical considerations that hospitals and physician practices should consider when contemplating such an acquisition.

Asset Purchase Versus Ownership Interest Purchase

Practice acquisitions either can be structured as a purchase of the assets of the physician practice or as a purchase of the ownership interest of a practice (stock in a corporation or membership interest in a limited liability company). The structure chosen has a significant impact on the tax burdens of each party, as well as who is responsible for the liabilities of the practice. Further, in advising your client, it is important to understand the other party's tax structure and its effect on your client's preferred transaction structure.

A sale of ownership interests generally is favored by the physicians since it will provide capital gains tax treatment and thus lower taxes. If the hospital is a not-for-profit entity, the tax treatment may not be as significant an issue than if the hospital is a for-profit entity. From the hospital's perspective, since the practice's existence as an entity will continue, assignment prohibitions in existing contracts may not need to be addressed. However, note that in some cases, the transfer of control of the entity still triggers the anti-assignment provisions. Notwithstanding this potential benefit of an ownership interest purchase, the hospital must consider the key detriment of a purchase of ownership, which is the continuation of the practice's liabilities (known, unknown and contingent).

Asset purchases generally are favored by the hospital since the hospital may contractually avoid liabilities by not specifically assuming them. The hospital can pick and choose which assets to purchase from the practice and which liabilities to assume from the practice. In addition, if the hospital is a for-profit entity, there may be significant tax advantages for the hospital in an asset purchase, such as a stepped up basis of the assets, which will increase the hospital's ability to depreciate them.

In an asset purchase, the hospital must perform appropriate due diligence and should review any title transfer issues and liens on assets. Further, the hospital may have to obtain numerous consents to assignments of contracts and obtain additional regulatory approvals. For the physicians, an asset sale may result in some additional taxes, including the potential recapture of excess depreciation and, if a C corporation, a possible double taxation of the sales proceeds.

Assets to be Purchased

In an asset purchase, the parties will need to negotiate which assets will be included and which assets will be excluded. If you are representing the selling practice, make sure that the physicians carefully review the asset list to be transferred prior to the contract being signed. This will ensure that assets they may deem to be "personal," which might be owned by the practice, are excluded assets and not transferred to the hospital as

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part of the deal. This could include the artwork hanging in the office or the furniture in their offices.

You should note that most physician practices do not have significant tangible assets, so valuating the practice strictly on a hard asset value might not properly reflect what the physician will deem the value of the practice. Whether the purchase price will include any payment for intangible assets, or goodwill, can be a hotly negotiated issue. In some cases, physicians request that the hospital not only pay for the going concern for the practice, but pay the goodwill directly to the physician owners rather than to their entity (especially if their entity is a C corporation, to save them the potential double taxation and create long term capital gains). Should any payment for goodwill be agreed to, appropriate support as to its fair market value must be obtained.

Should the physician practice negotiate to retain its accounts receivable, there needs to be appropriate planning to enable the practice to utilize the transferred employees and equipment to assist in the collections process, if needed.

Leased Assets and Contract Consents

In many instances, offices and/or equipment that are used by the physician practice are owned by a separate entity and leased to the practice. In these cases, the physicians may want the hospital's entity to assume those leases. The hospital, in those circumstances, should assess whether it will assume those leases and if so, under what terms and conditions. After appropriate due diligence, the hospital should determine if the consent of the lessor is required to assign that lease.

Sometimes, the physicians may have personally guaranteed the leases and will want to be relieved of their personal obligations. Moreover, the lessor still may demand a guaranty of the lessee's obligations. This may create tension between the practice and hospital as to whether the physicians' personal guaranty will continue, or if the hospital will provide its guaranty and whether the lessor will permit the substitution of the guarantor.

Also, as part of the hospital's due diligence, the hospital must determine if the practice is a party to any contracts, leases or other relationships with related parties, such as the physicians or their family members (or entities owned by them). In those instances, the hospital must carefully consider whether these relationships still are needed and if so, whether the terms are appropriate from a regulatory perspective.

Fair Market Value and Commercial Reasonableness

If the physicians in the practice will make referrals of patients to the hospital and/or if the hospital will refer patients to the practice, it is absolutely vital for the remuneration paid under the purchase and sale transaction (as well as any post transaction employment) to be fair market value and that the transaction as a whole be commercially reasonable. The purchase must be reasonable even if there were no referrals between the parties. In these instances, a reputable third party valuation company should be retained. Both parties should review the valuation and methods used in determining fair market value.

Employees

Commitments to hire the employees of the physician practice also may be the subject of negotiation. When family members are employed in the practice, the hospital will want to assess their qualifications, duties, salaries and benefits and assure that their compensation is consistent with hospital ranges for comparable positions. If you represent the practice, try to make sure the physicians will have post-closing input in the hiring and firing of their staff.

Restrictive Covenant

In states that permit physician restrictive covenants, a noncompetition provision may be important from the hospital's perspective. A restrictive covenant generally will be negotiated as part of the employment agreement, the purchase agreement, or both. The scope of the covenant that will be enforceable will depend on state law, but generally it will be hotly negotiated. For instance, physicians frequently desire to be released from a noncompetition covenant if the hospital entity terminates their employment without cause. The hospital, however, will want to assure that it has a covenant adequate to protect its investment in the practice and that does not restrict the hospital's ability to terminate the physician's employment if the relationship is unsatisfactory.

Conclusion

It is vital for hospitals and physician practices to consider the issues identified in this article along with many other issues when contemplating a hospital acquisition of a physician practice. Although a detailed discussion of physician compensation post-closing is not explored in this article due to the numerous models available and the varying factors to be considered when determining a model that best fits, it should not be ignored. Both parties should realize that each transaction must be evaluated on an individual basis based on all of the facts and circumstances. There is no such thing as a one-size-fits-all acquisition model. Although the long-term consequences of health care reform obviously remain indeterminable in the short-term, hospital acquisitions of physician practices likely remain a viable option for the foreseeable future.

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