Joint VENTURES

Why Would My Hospital or Practice Want One?

by Kevin M. Kennedy, MBA, and Todd Greenwalt, JD

Joint ventures between hospital-based cancer programs and private oncology practices have become increasingly common in recent years. While a number of factors have contributed to this trend, the migration of many cancer services to the outpatient arena is perhaps the most important underlying cause. Today, many physician practices offer a full range of ancillary services that typically were provided in the hospital inpatient setting. In fact, physician development of ancillary revenue streams has become so common that new physician recruits often consider this a major selling point in deciding which practice to join. Joint ventures between hospital-based cancer programs and physician practices are often an attempt to work together in a way that acknowledges this reality.

One Size Does *Not* Fit All

Hospital-based cancer programs and physician practices can joint venture in a number of ways and with varying levels of economic integration; however, legal limitations and the current economic climate have resulted in several common structures. Most joint ventures are a variation of two main options—shared ownership of a for-profit entity or a "virtual" agreement in which interests are aligned and defined by contractual terms, but ownership is not shared. A third option that has recently gained notice is a joint venture that has physicians participating as bondholders.

1. While no "cookie-cutter" model exists, an *equity joint venture* is the most common structure for a joint venture. Under this option, the hospital-based cancer program and the physician practice create a new "entity" that offers specialized clinical services. The most common joint ventures for cancer centers involve radiation therapy and chemotherapy infusion, but most outpatient-oriented services are potential candidates.

Under an equity joint venture, each party's ownership percentage is determined by how much money it invests. The contribution can be cash, equipment, or the value of an existing business. Often, the hospital will contribute an existing business, and physicians will make a cash contribution. In this type of joint venture, the "owners" share management responsibilities, and the ability to buy or sell ownership in the venture is strictly controlled to protect all partners. To ensure commitment and to protect the joint venture, the hospital and the physician practice may agree to a non-compete clause.

2. The second most common form of joint venture between hospital-based cancer programs and physician practices is *contractual* (i.e., "virtual") *agreements*. A contractual joint venture can provide an equivalent sharing of risk and rewards, creating a strong incentive for the hospital and physician practice to work toward mutual goals. In addition, a contractual joint venture may also be faster and easier to develop because of the lower up-front investment and reduced legal requirements.

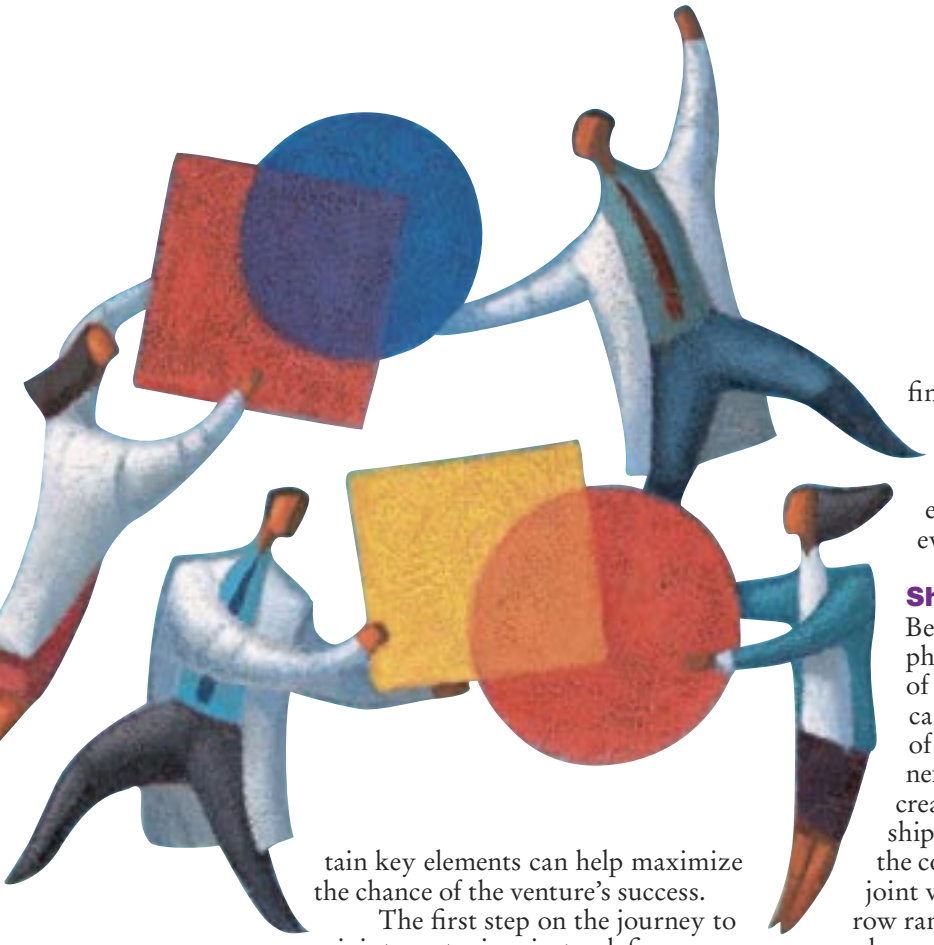
Physician management contracting is an example of a contractual joint venture. Under this model, physicians form a new company to manage a hospital-owned service, such as chemotherapy infusion. In this type of joint venture, the physicians have significant management control and even share, to a degree, in the financial success of the new business entity. Physician management contracting requires a relatively low level of physician investment and may be a good choice for practices with limited capital. Conversely, the financial return may not achieve the levels of a true equity investment.

3. A third type of joint venture is the *participating bond structure*, which is designed to create a high-yield, tax-free revenue stream for physician investors. The participating bond structure involves the creation of a tax-exempt, nonprofit corporation. In this type of joint venture, a tax-exempt hospital controls and owns an outpatient surgery center or diagnostic facility. Tax-exempt debt, both senior and subordinate, is issued on behalf of the controlled affiliate (hospital) for use in the acquisition and construction of the project. The senior debt is secured by the joint venture's assets and gross revenues, and in some cases, benefits from a hospital guarantee. In contrast, the subordinate debt is payable only from joint venture cash flow. The affiliate also may enter into a management agreement with physician investors for management of the facility.

In the participating bond structure, the physicians do not directly own an interest in the joint venture. The physician interests consist of subordinate bonds, and in some cases, participation in the management contract revenues. The subordinate debt offers more risk than the senior debt and, thus, carries a higher interest rate. Because the interest paid is not subject to tax, the after-tax yield to physician investors who purchase the subordinate debt is higher than the actual interest rate and may approach the returns available in equity joint ventures. The management contract, if included in the structure, provides an additional revenue stream to physician investors.

Getting Started

Developing a joint venture is a time-consuming, complex process for both parties—the hospital-based cancer program and the physician practice. Joint ventures involve significant financial stakes and thoughtful, thorough strategic planning. A successful joint venture can strengthen the bond between a hospital and the physicians in its community. An unsuccessful joint venture can damage—sometimes irreparably—this important relationship. Cer-



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tain key elements can help maximize the chance of the venture's success.

The first step on the journey to joint venturing is to define your goals in advance. A forthright discussion about what each party (the hospital and the physician practice) hopes to achieve is the best way to ensure expectations are understood.

Understand the true impact a joint venture will have on your bottom line. A thorough financial understanding is especially important for the hospital, which may be faced with losing revenue to the venture. Factors such as potentially reduced managed care contract rates, loss of provider-based reimbursement status, and transferred volume must all be factored into a comprehensive financial assessment of what the venture will really cost.

You must also understand the legal and regulatory issues involved with the joint venture. Many of these regulatory aspects fall within broad "gray areas" that are neither sanctioned nor expressly prohibited by law. Joint ventures are a specialized, complex area of healthcare law. Working with competent, experienced legal counsel to understand and mitigate any risk is prudent from both a business and a mental health perspective. (See box on page 28 for a more thorough discussion of the regulatory and legal issues involved with joint venturing.)

A successful joint venture involves building consensus and getting buy-in from all key participants. As with any major initiative, participants will respond more favorably to a joint venture proposal if they have the opportunity to influence its design. When designing a joint venture, check in with key constituents, such as board members or potential investors, at various times during the process to ensure their comfort with the project's direction.

The final step is to prepare a business plan that will describe the operations, management, and projected financial performance of the joint venture. The document itself will be useful in managing the joint venture, but the process of discussing the relevant issues and setting common expectations among venture partners may be even more valuable.

Should You Or Shouldn't You?

Because hospital-based cancer programs and physician practices serve a common mission of offering quality care to their patients with cancer, they often work together in a number of ways. And taking that cooperation to the next level—engaging in a joint venture—can create a strong level of cooperation and partnership between the hospital and the physicians in the community. Keep in mind, however, that most joint ventures are typically structured across a narrow range of the hospitals' and physicians' activities, and may have limited ability to create a truly strong relationship.

Maybe a joint venture is really *not* the best solution for your hospital/practice. Joint ventures are merely one way for physicians and hospitals to work together. Other options—from medical directorships to employment—may offer better mechanisms to achieve the parties' goals.

Before your hospital or physician practice commits to a joint venture, you must clearly recognize and understand the pros and cons involved with such a project. Hospital/physician relationships are perhaps the most heavily regulated aspect of the healthcare industry. In fact, numerous barriers—for both hospitals and physicians—make joint ventures difficult to develop, even under the best of circumstances.

Once a decision has been made to pursue a joint venture, hospital-based cancer programs tend to move forward in a unified fashion that reflects their hierarchical decision-making processes. On the other hand, individual physicians tend to have their own unique sets of issues that reflect diverse needs. For example, a practice can have a mix of young physicians, who do not have investable capital, and older physicians, who are close to retirement and may have a shorter investment horizon. Building consensus within the medical practice is a difficult but essential task when developing a joint venture.

On the hospital side of the joint venture equation, the loss of revenue is often a primary concern. For example, a hospital that is operating a successful radiation therapy unit may find the prospect of giving up 50 percent of its revenue to a joint venture to be an unattractive option. Also, the joint venture will often forgo more lucrative hospital-based reimbursement when a service is transferred

Regulatory and Legal Considerations

Legal and regulatory considerations (i.e., the Medicare Anti-Kickback Statute and the Stark law) must be taken into account when structuring any joint venture. In addition certain tax rules come into play when the hospital participant is tax-exempt.

The Medicare Anti-Kickback Statute. This law generally prohibits the offer or solicitation of value in exchange for the referral of a government-insured patient service opportunity. Because healthcare joint ventures involve physicians who are in a position to refer patients to a facility, the hospital and practice should ensure that specialized legal experts are involved to ensure that the joint venture does not violate the Anti-Kickback Statute.

Typically, anti-kickback issues are minimized by identifying and structuring joint ventures to conform with safe harbors promulgated under the Anti-Kickback Statute. In the context of joint ventures, three possible safe harbors are offered: investment interests in small entities; investment interests in underserved areas; and investment interests in ambulatory surgery centers. Meeting all three aspects of a safe harbor is difficult, so joint ventures are typically structured to come as close as possible to one or more of these safe harbors. Under each safe harbor, steps must be taken to ensure proper valuation of assets and payments to participants that do not exceed reasonable compensation. In certain cases, the percentage of physician ownership may be limited.

The Stark law. Unlike the Medicare Anti-Kickback Statute, this absolutely prohibits government-insured patient referrals in situations where there is a financial relationship between a referring physician and a health service provider.

The typical joint venture creates financial relationships among the parties that seemingly violate the Stark Law; however, the Stark law sets forth exceptions pursuant to which otherwise impermissible referrals can occur. Exceptions to the Stark law generally exempt the relationship created between a physician investor and a hospital in a joint venture so long as the financial relationship reflects arm's-length compensation or fair market value. The technical nature of the exceptions to the Stark law mandate careful legal review.

Tax-exempt status. Regardless of the type of joint venture into which a tax-exempt hospital enters or the nature of the interest in the joint venture that it holds, a tax-exempt hospital participating in a joint venture would lose its tax-exempt status in two situations. For example, if the hospital served a substantial non-charitable purpose through its participation in the joint venture (e.g., the hospital's primary purpose was to participate in the joint venture and the function of the joint venture was unrelated to the charitable purposes of the hospital), the hospital would lose its tax-exempt status. If the hospital's participation in the joint venture resulted in benefits to private parties that were not supported by services or property received, the hospital would also lose its tax-exempt status.

In recent years, the IRS has focused on control of the joint venture to determine the tax consequences for tax-exempt hospital participants.

In the context of ancillary joint ventures—joint ventures involving diagnostic, outpatient, or similar services—the IRS has indicated that, overall, control issues are subordinate to control by the tax-exempt hospital over the activities that bear directly on the accomplishment of charitable purposes.[1] In other words, if the tax-exempt hospital exercises control over patient access, billing, and other joint venture activities that bear directly on the provision of community benefits and the legal documents mandate that the joint venture generally operates in a manner consistent with charitable purposes (i.e., providing healthcare to the public at large), the hospital's tax-exempt status is protected and income from the joint venture will not be taxable. This approach presents a more liberal position than the IRS has taken previously.

References

[1] Rev. Rul. 2004-51, 2004-22 I.R.B. 974 (June 1, 2004).

or sold to a joint venture. This is often considered money "left on the table" and can provide a powerful motivation to consider other options.

Hospitals should be prepared for a tough sell to management and board members, even if the joint venture makes perfect sense compared with the alternative of losing the business to an entrepreneurial physician group that may be able to direct this business to an entity they own.

In today's challenging healthcare environment, joint ventures remain a popular method for hospitals and physicians to work together to provide quality cancer care to the patients in their community, and many examples of successful joint-ventured oncology enterprises support this trend. A joint venture creates ownership and a sense of investment and commitment between the hospital-based cancer program and the physician practice. A joint venture also allows the hospital and practice to leverage the unique expertise each brings to the table.

For the hospital-based cancer program, a joint venture demonstrates a "good faith" effort of working with the physicians in their community. Joint ventures foster cooperative relationships and help secure a service that may otherwise be at risk of leaving the facility.

For physician practices, a joint venture with a hospital-based cancer program may be attractive for several reasons, including access to capital, the hospital's reputation within the community, and the hospital's legal and contracting expertise. For physician practices, a joint venture with a hospital may offer a lower risk level than an independent venture. Even more important, a joint venture with a hospital-based cancer program can help support physician incomes and moderate the impact of adverse reimbursement changes.

Kevin M. Kennedy, MBA, is a principal with ECG Management Consultants, Inc., in Seattle, Wash., and Todd Greenwalt, JD, is a partner with the law firm of Vinson & Elkins, Houston, Tex.