CONSOLIDATION OF MEDICAL PRACTICES

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R. Terry Heath, Esq.
Hall, Render, Killian, Heath & Lyman, P.C.
One American Square, Suite 2000
Indianapolis, Indiana 46282
Phone: (317) 977-1410
FAX: (317) 633-4878
E-mail: theath@hallrender.com

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HALL RENDER
KILLIAN HEATH & LYMAN

AGENDA

- Purposes/objectives behind consolidations.
- Basic Plan of Organization.
- Ownership Structure.
- Governance Mode.
- Compensation Model
- Covenant Not to Compete.
- Buy/Sell Arrangement.
- Redemption Events.
- Other Issues.

PRACTICE TRENDS

Study Finds Physicians Increasingly Practice in Mid-Sized, Single-Specialty Groups.

According to a study released August 16 by the Center for Studying Health System Change ("HSC"), the proportion of physicians in solo and two-physician practices decreased "significantly" from 40.7% in 1996-97 to 32.5% in 2004-05. In addition, the study found the proportion of physicians in multispecialty practices decreased from 30.9% in 1998-99 to 27.5% in 2004-05. Instead, "[p]hysicians increasingly are practicing in mid-sized, single-specialty groups of six to 50 physicians," the study said.

PURPOSE / OBJECTIVE

- Commonly cited reasons for consolidating medical practices include:
  - To best realize value in the marketplace.
  - Improve quality of care (through peer review and other methods of knowledge sharing)
  - Be able to more easily (both legally and financially) engage in the provision of ancillary care, resulting in better quality and new revenues.
  - Be better able to afford:
    - More sophisticated practice management; and
    - More effective marketing

PURPOSE / OBJECTIVE

- Help with recruiting highly qualified physicians.
- Be better able to afford more sophisticated systems (e.g., be able to afford systems that capture data electronically, analyze it, and turn it into a useful tool for quality improvement or marketing).
- Economies of scale (possible, but often overstated).
  - Staff (billing and collection)
  - Space
  - Management
- To enhance overall value of practice to the market.

PURPOSE / OBJECTIVE

- Federal and State antitrust laws preclude consolidation of competitors for the purpose of gaining "leverage," or power, over payers. In order to enjoy many of these benefits, federal and state antitrust laws will require sufficient "integration" of the entire group to cause the new practice to be considered a single business entity.
- So long as no monopoly power arises, competitors may consolidate operations with a view to improve quality, create better systems, or even make more money by economies of scale.
  - *Per Se* Violation vs. "Rule of Reason."
  - Do the procompetitive effects of the consolidation outweigh the anticompetitive effects → Balancing Act.

PURPOSE / OBJECTIVE

- If divisional autonomy is present in newly created practice, a natural tension will exist between it and antitrust laws.
  - There may be integration at the "top" of the organization, but not at the middle and the bottom.

BASIC PLAN OF ORGANIZATION

- Newco will be formed with several “divisions.” Each “old” practice will be considered a separate division within Newco. (Analogy: General Motors with Chevrolet, Cadillac, Pontiac, etc.)
- Merger of existing corporate practices is disfavored because of potential "sharing" of existing liabilities.

BASIC PLAN OF ORGANIZATION

- Old entities will be maintained, but will cease being health care providers.
  - They will continue to own the assets they currently own and lease those assets to Newco for use by the related Division. Those lease payments will be an expense of that Division.
  - Space leased by the old entity (from a 3rd party lessor) will be subleased to Newco for use by the related Division. Those sublease payments will be an expense of that Division.
  - The leases and subleases noted above will be terminable by Newco on short notice so Newco will not be burdened by those payments in the event the physicians assigned to the related Division leave Newco; alternatively, the physicians in each Division could personally guarantee some or all of their Division's lease.

BASIC PLAN OF ORGANIZATION

- The old entities will maintain their accounts receivable, collect them, and pay them out as deferred compensation as received. Deferred compensation bonuses may need to be declared before the old entities cease providing medical services.
- The old entities may need to revise their corporate documents to accommodate their new functions. This process can be standardized with "template" documents.
- The old entities will not transfer goodwill to Newco.

- New equipment to be purchased by Newco in the future may be purchased directly by Newco. Alternatively, either an old entity, or a consortium of two or more of the old entities could purchase that equipment and lease it to Newco.

TYPE OF ENTITY SELECTION

- When possible, Newco is usually formed as a "pass thru entity" (typically a limited liability company).
  - Afforded the liability shield of a corporation.
  - Taxed as a partnership.

OWNERSHIP

- Equal ownership for all shareholders? Yes, assumed, but doesn't have to be.
- Sample Productivity Rule: No physician may maintain ownership unless he or she produces charges equal to 60% (??) of average charges over a two year period for a full time doctor in Newco, not including ancillary services.

GOVERNANCE

- General Scheme – Republic.
- With distinct divisions, "House vs. Senate" issues.
- Certain matters being subject to a super-majority Board vote will be appropriate.
- Special Rules for Founding Owners – In light of past service in old entities, certain founding physicians might enjoy “Founders’ Rights” regardless of the number of owners. For example:
  - special rule regarding termination;
  - upon "divorce," ability to maintain office space, staff, & equipment;

GOVERNANCE

- special veto rights regarding (i) admission of new shareholders, (ii) merger of practice into another, (iii) sale of all or substantially all of the practice's assets, (iv) moving the practice location or creating a new practice location, (v) purchasing or leasing an asset that costs in excess of $X, (vi) employment of new physicians by Corporation, and (vii) adjustment of physician compensation arrangements.

Governance Model--Example

Assume:

- 47 full time owners.
- 5 part time owners.
- All 52 owners own equal membership interests.
- 9 divisions in Newco as follows:
  - A. Division A – 14 owners
  - B. Division B – 10 owners
  - C. Division C – 6 owners
  - D. Division D – 6 owners
  - E. Division E – 6 owners
  - F. Division F – 5 owners
  - G. Division G – 3 owners
  - H. Division H – 1 owner
  - I. Division I – 1 owner

Governance Model--Example

Governance Philosophy:

- "Republic" form of governance necessary (to avoid a 47 person governing body).
- Decisions that, "for all practical purposes, solely affect only the Divisions," should be made by the Divisions ("Division Decisions").
- Decisions that affect Newco at large as well as more than one Division, should be made by Newco ("Newco Decisions").

Governance Model--Example

<u>Governance Philosophy</u>:

- With regard to Newco Decisions, the larger Divisions should have greater voting power, but all Divisions should have some minimal level of input and protection.
- No special rules for founding owners.
- No business matters to be voted on by the owners except election of Board members. *[Check state law for any matters that might need to be voted on by owners.]*

Governance Model--Example

Governance Arrangement:

- Division Decisions – Unless altered in writing by 90% or more of the owners in a particular Division, Division Decisions of that Division shall be made in the same manner by which decisions in the existing entities are made. These arrangements will be set forth in writings and referred to in the Newco Operating Agreement. All of the owners of each Division shall participate in these matters regardless of whether or not they are full-time or part-time physicians. *[Query: Should full-time and part-time physicians should have equal ownership and voting rights?]*

Governance Model--Example

Governance Arrangement:

- Examples of Division Decisions would include the following:
  - Selection of space in which Division is located (rent for which is a Divisional Expense).
  - Selection of Division specific staff (costs for which are Divisional Expenses).
  - Selection of Equipment.
  - Selection of Supplies.
  - Vacation/CME Policy.

Governance Model--Example

Governance Arrangement:

- Newco Decisions
  - Newco Board of Managers established which would be comprised of Managers elected in the following manner.

Governance Model--Example

# of Owners* Assigned to Division	# of Managers on Board
1 thru 4	See Special Rule**
5 thru 9	1
10 thru 14	2
15 thru 19	3
20 thru 24	4
etc.	

* Includes both full time and part time owners of Newco; provided, however, no physician may continue as an owner of Newco unless he or she practices at least 60% of a full time practice. (Those physicians who slow down below that threshold may have their Newco ownership redeemed and may become employed physicians on terms agreeable to Newco and the Division to which they are assigned)

** Special Rule: All of the Newco owners in Divisions with 4 or fewer Newco owners assigned to those Divisions shall be aggregated and, by majority vote, shall elect the following number of Managers, depending on the number of such Newco owners in such Divisions.

Governance Model--Example

Total # of Owners* Assigned to Divisions with 4 or fewer Owners	# of Managers on Board
1 thru 9	See Special Rule**
10 thru 14	1
15 thru 19	2
etc.	3

Based on the example of Division sizes set forth above, Newco's initial Board would have 9 members, appointed by:

Division A – 2 Managers,
Division B – 2 Managers,
Division C – 1 Manager,
Division D – 1 Manager,
Division E – 1 Manager,
Division F – 1 Manager, and
Divisions G, H & I collectively – 1 Manager.

Governance Model--Example

Governance Arrangement:

- All Newco Decision, except "Super-Majority Decisions," would be made by majority vote of the Board of Managers.
- Super-Majority Decisions would require vote of at least 80% of the Board of Managers.
- Examples of a few Non-Super-Majority Decisions (which should be defined generally, but include several binding examples) include the following:
  - Selection of centralized billing system (costs for which are General Overhead Expenses).
  - Selection of central office space (costs for which are General Overhead Expenses).
  - Managed care contracting. (No one division will be allowed to contract separately.)
  - Admission of new owners.

Governance Model--Example

Governance Arrangement:

- Examples of a few of the Super-Majority Decisions (which should be defined generally, but with several binding examples) include the following:
  - Termination of an Owner Physician's Employment (and Ownership).
  - Changes to Compensation Arrangements.
  - Addition of a New Division.
  - Merger or sale of all or substantially all of Newco's assets.
  - Purchasing or leasing an asset that costs in excess of $X.
  - Others.

COMPENSATION

- No perfect arrangement.
- Should properly balance individual performance and teamwork.
- Part science, part philosophy, part math, should be void of voodoo.

Individual Physician's Compensation Formula--Example

Assume:

- Dr. John Doe works within Newco's Division "A."
- Newco has 52 physicians in its various divisions (some part-time and some full-time).
- A matrix would exist denoting all expenses as "General," "Divisional," or "Personal."
- Treatment of depreciation and amortization will need to be considered.

Individual Physician's Compensation Formula--Example

Dr. Doe's salary could equal (i) that portion of the "Division Dollars Available for Salary" (as computed in the formula set forth below) that is allocated to Dr. Doe by a majority vote of the owner physicians who practice in Division A (such owners voting in a manner that is proportional to their ownership in Newco), (ii) reduced by Dr. Doe's Personal Expenses:

Individual Physician's Compensation Formula--Example

Division A's Net Receipts for a Given Period of Time [1]

\- Division A's Share of General Overhead Expenses [2]

\- Division A's Divisional Expenses [3]

Division Dollars Available for Salary

Portion Allocated to Dr. Doe [4]

Dr. Doe's Tentative Salary

\- Dr. Doe's Personal Expenses [5]

Dr. Doe's Compensation [6]

Individual Physician's Compensation Formula--Example

[1] This starting point could be computed using cash receipts, accrued charges, monies related to RVUs, combinations of receipts and RVUs, or any number of other methodologies. It should include all monies generated (e.g., "buy-in" monies) by the Division, not just patient revenues.

[2] Division A's Share of General Overhead Expenses might be established on a per physicians basis. If so, with 10 of 40 physicians, Division A's share would be 25%. Assuming billing is centralized, an example of General Overhead would be rent, staffing, and IT costs associated with billing.

[3] Examples of Divisional Expenses would be divisional location rent and divisional staff working solely for Division A.

Individual Physician's Compensation Formula--Example

[4] The Division Dollars Available for Salary could be allocated by each Division differently. For example, Division A might allocate its DDAS equally among its owner-physicians. On the other hand, Division B might allocate its DDAS among its owner-physicians in proportion to their billings. Division C might allocates its DDAS in a third manner, etc.

[5]An example of Dr. Doe's Personal Expenses might be his travel and entertainment expenses.

[6] Actual compensation could be estimated during the year and "settled up" (either with payments or reductions of future compensation) after periodic computations of the correct compensation. If compensation is estimated, Newco should be careful not to "overpay" physicians to the point that settle up become too burdensome on the physicians.

LAB (or some other DHS) WITHIN NEWCO

- Overall profits generated by the Lab will first be allocated among groups of 5 or more physicians (be they owners or non-owners). The natural groups for such allocations will be the Divisions, however, Divisions with fewer than 5 physicians could be aggregated into groups of at least 5 physicians.
- Within the groups of 5 or more physicians, those profits would be further allocated in a Stark Law compliant manner.
  - Per capita.
  - In proportion to individual professional collections expressed as a percentage of total collections of the Division or Newco.
  - Some other methodology that is not tied directly to the volume or value of referrals of Lab.

"There can be no doubt but that the statutes and provisions in question, involving the financing of Medicare and Medicaid, are among the most completely impenetrable texts within human experience. Indeed, one approaches them at the level of specificity herein demanded with dread, for not only are they dense reading of the most tortuous kind, but Congress also revisits the area frequently, generously cutting and pruning in the process and making any solid grasp of matters addressed merely a passing phase."

--Chief Judge Ervin, United States Court of Appeals for the 4th Circuit in Rehabilitation Association of Virginia v. Kozlowski, 42 F. 3d 1444, 1450 (4th Circuit 1994)

COVENANT NOT TO COMPETE

- Used to protect Newco's ability to generate revenue.
- Must be "reasonable" in terms of:
  - Duration (during employment and 1-2 years thereafter).
  - Scope (limited to specialty and ancillaries).
  - Geographic Restriction (primary and secondary market area—by radius, county, zip code, or other objective measure).
- Liquidated Damages.

Covenant Not to Compete

- Covenant Not to Compete: Would apply to the practice of gastroenterology and general internal medicine within Restricted Area.
- Excepted Activities: Teaching position, but the private practice associated with a teaching position would not be excepted.
- Restricted Area: Within ten (10) miles of any Newco office or offices at which Physician practiced medicine on behalf of Newco at any time within the twenty four (24) months immediately prior to the termination of such employment.

Covenant Not to Compete--Example

- Term of Covenant: During employment and for eighteen months after termination of employment, regardless of the reason for such termination.
- Liquidated Damages: Covenant could be "bought out" for the following liquidated damages:

Employment terminates within first year	$250,000
Employment terminates within second year	$200,000
Employment terminates within third year	$150,000
Employment terminates thereafter	$100,000

BUY-SELL / SEVERANCE ARRANGEMENT

- In reality, medical practices are comprised of little "goodwill value."
- Cessation of employment as physician will be linked to cessation of ownership.
- Mandatory retirement age for owners of 72 (Could be waived by Newco Executive Committee)
- Standard Arrangement
  - Severance equal to 90% of the departing physician's accounts receivable collected over the six months immediately following departure.
  - Ownership interest redemption equal to "book value" of assets and liabilities, or "capital account" of Newco.

Terms of Redemption of Ownership Interests in Matrix--Examples

Reason for Departure	Required Redemption Or Newco's Option	Redemption Price
Death	Required	Severance [7] + 100% of Capital Account
Disability [8]	Required	Severance + 100% of Capital Account
Retirement [9] (No Competition)	Required	Severance + 100% of Capital Account
Bankruptcy or Receivership of Owner	Required	Severance + 100% of Capital Account
Separation for Newco's Breach	Required	Severance + 100% of Capital Account
Termination by Newco without Cause	Required	Severance + 100% of Capital Account
Separation for Physician's Breach	Required	No Severance + $1.00
Voluntary Withdrawal (Competition)	Required	No Severance + $1.00

7 See Section 8.3.1 for definition of "Severance."
8 "Disability" is defined as __________.
9 "Retirement" is defined as ___________.

PLANS FOR FUTURE BUY-IN

- Decisions can be made when new physician actually becomes owner. Division in which the new physician will practice will set purchase price.
- Suggest "Plan of Action" be worked out presently to avoid issues later.
- Need to discuss the balance between Divisions and Newco of decisions to hire new physicians or allow a physician to become a new owner.
- Most of "Buy-in" monies will be allocated to the owners of the Division in which the physician will practice.

RETIREMENT AND WELFARE BENEFIT PLANS

- For legal and business reasons, will generally need to agree to standard benefits to be offered.
- Self-directed retirement plan investment accounts may be necessary.

MISCELLANEOUS

- Current debt.
- Vacations / CME.
- Outside income.
- Other.