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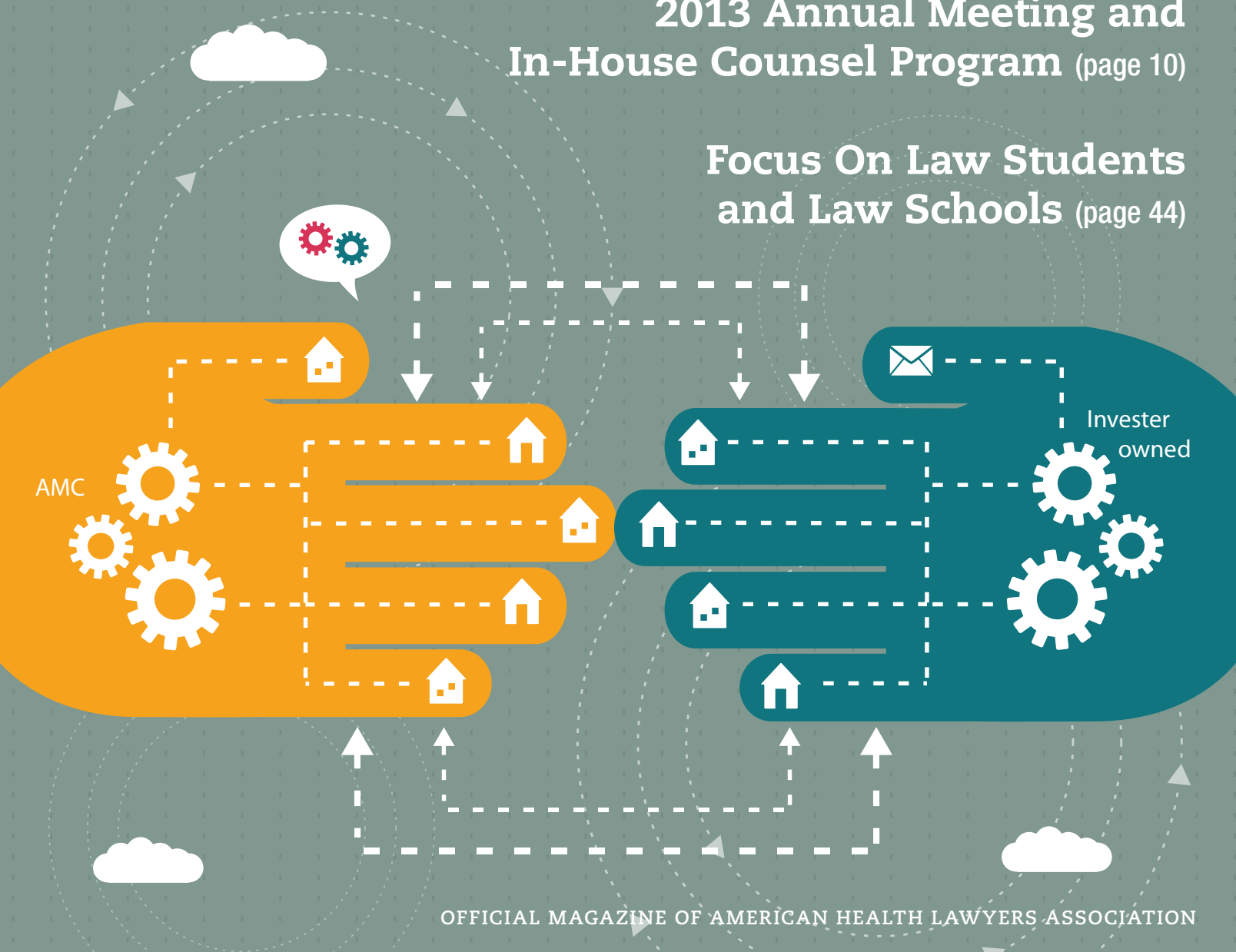
For the health and life sciences law community

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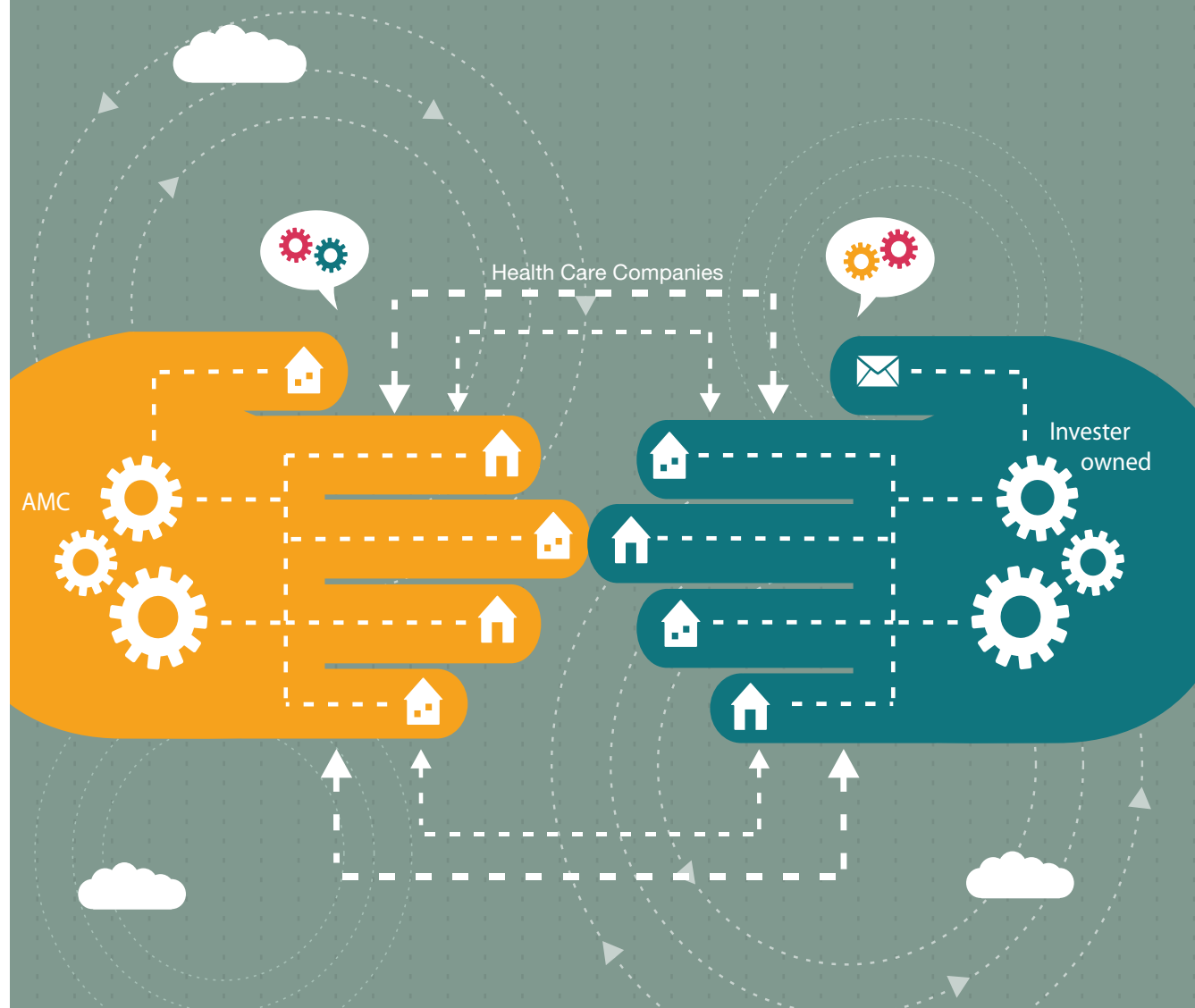


Increasingly Common Bedfellows— Collaborations Between Academic Medical Centers and Investor-Owned Health Care Companies

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Over the past several years, a number of innovative strategic partnerships have been formed between Academic Medical Centers (AMCs) and investor-owned health care companies. Examples include the Cleveland Clinic and Community Health Systems (NYSE: CYH) service line collaboration announced in March 2013; Duke

University Health System and LifePoint Hospitals Inc. (Nasdaq: LPNT) establishing a joint venture “to own and operate a system of highly functioning community hospitals”;¹ and Shands HealthCare partnering with Health Management Associates Inc. to jointly own and operate three community hospitals.²



What's Driving the Trend?

While single hospital joint ventures between tax-exempt providers and investor-owned companies or ancillary service line joint ventures between AMCs and investor-owned companies are not revolutionary ideas, the scope of the relationships is certainly expanding. Following the passage of the Affordable Care Act (ACA) in March 2010 and the Supreme Court's decision in June 2012 upholding (for the most part) the constitutionality of the ACA, several factors may be influencing the willingness of both AMCs and investor-owned companies to explore these kinds of game-changing relationships.


The access to capital that investor-owned companies are able to provide in these relationships is often a key consideration as AMCs work to find their footing on the shifting sands of payment reform and evolving reimbursement models. In some instances, an AMC might be motivated to enter a joint venture to ensure the economic future of its medical education program. Equally important for the AMCs is finding suitable allies with which they can form accountable care organizations and position themselves competitively as bundled payments, shared savings, and other emerging payment models come online. AMCs also can benefit from the management expertise, group purchasing negotiating leverage, and operational insight that their investor-owned partners can provide. Larger tax-exempt systems, particularly those built around high-profile AMCs, also may see partnerships with investor-owned companies as a way to develop new networks or expand into new regions when they find themselves geographically limited within their traditional markets.

For the investor-owned companies, partnering with AMCs can bring access to new markets and new patient populations. In addition to increased critical mass, the investor-owned partners benefit from the brand awareness provided by a joint venture with a well-known and well-respected AMC. Equally attractive is an AMC partner's expertise with respect to clinical quality and specialized medical services.

Sharing a Vision and Merging Two Cultures

As with any joint venture, the ultimate success of a collaboration between an AMC and an investor-owned company begins with establishing a clearly defined objective. The first critical issue is whether the parties share the same goals for the joint venture. Ensuring that each party's goals for the new partnership are aligned is of paramount importance. If, for instance, the AMC's primary goal is to solidify its market share within a particular region while the investor-owned partner views the joint venture as a means of moving into a new market for future expansion, there is little likelihood that both objectives can be achieved simultaneously.

If the goals of the parties are closely aligned and the approach has been agreed upon, the next issue to consider is how each party will seek to achieve the goals of the joint venture within their respective organizations. These separate approaches can have significant impact on how well the joint venture functions. It is important to be mindful of differences



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in organizational styles with respect to the decision-making process. Focusing on the larger objectives of the joint venture rather than how one party or the other customarily arrives at a decision will increase the likelihood of success.

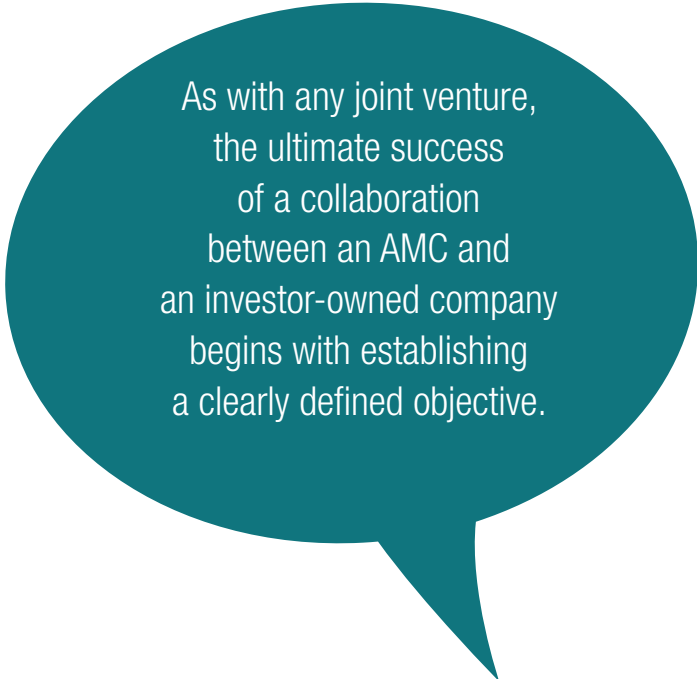
Finally, the commitment of each party to the joint venture is key. If one of the partners is accustomed to getting what it wants all the time, it can be difficult to adapt to a relationship in which compromise and the adjustment of expectations may be necessary. Simply put, it is a *partnership* not a one-time zero-sum negotiation between adversaries.

It's Not All About the Money, But . . .

From the outset, the economic aspects of the joint venture need to be carefully delineated and understood by each party. The basic questions to be answered include:

- » Who is investing how much capital?
- » Who will decide when additional capital will be contributed?
- » How will profits be shared and losses be funded?
- » How will the decisions concerning distribution of "excess cash" be made?

If these questions are not adequately addressed during the formation of the joint venture, a potentially profitable and productive relationship can quickly become a sinkhole absorbing not only management time that may be better spent elsewhere but also limited monetary resources. Several years back, a three-party relationship was established with the intent of securing the future of a particular AMC. The relationship unraveled when money that the AMC expected one of its partners to spend for certain purposes was spent elsewhere. As a result, the AMC then decided to spend money on a project that it previously had indicated would be invested elsewhere. Not surprisingly, things only got worse. The parties could have



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avoided this unfortunate downhill slide (and the resulting litigation) if they had been willing to openly discuss their respective views on the economic issues at the outset.

Who's Driving?

Delineating how the joint venture makes decisions is always an important element in creating a successful enterprise. Establishing a governing body with members appointed by each party is a common approach. While the governing body makes decisions concerning matters that are more often strategic in nature (e.g., the acquisition of a business, approval of strategic plans, budgets, etc.), the day-to-day operation of the joint venture typically is delegated to one of the parties pursuant to a management agreement, usually the investor-owned company that brings this expertise to the partnership. Control over the academic and research components of the joint venture will inevitably be retained by the AMC. The critical path here is making sure that the parties are philosophically aligned with respect to these issues. Once that is done and trust is established through the operation of the venture over time, the language in the applicable governing documents becomes merely a guidepost or reminder of that initial meeting of the minds.

Whether the relative governance rights of the parties should mirror the financial rights and obligations of the parties (i.e., capital contributions) is a material issue. If more of the investor-owned company's capital is at risk than the AMC's capital, why should each partner have an equal say about decisions that ultimately impact the return on the investor-owned company's capital? Frequently, that is the "price" of cementing such a relationship (especially if that is one of the primary reasons the AMC is considering such a relationship) with certain agreed upon limitations. Conversely, if the parties are "partners," shouldn't they agree on materially important actions taken or not taken by the joint venture?

In some instances, there may be outside factors that influence whether the AMC and its partner will have equal governance rights. *St. David's Health Care System v. United States* and Internal Revenue Service Revenue Ruling 98-15 (both of which address the contribution of a tax-exempt hospital to a joint venture with an investor-owned company) place a great deal of emphasis on the ability of the tax-exempt entity to "control" the joint venture or at least certain aspects of its operations. Although the guidance provided by these rulings is not an absolute set of requirements for maintaining the AMC's tax-exempt status when it contributes a whole hospital to the joint venture, it is certainly less material when the joint venture involves downstream or ancillary activities and the AMC maintains many additional avenues to retaining its tax-exempt status.

Even if the AMC and its partner do not equally share governance, there may be certain items that are so material to fostering the partnership mentality that the approval of both parties is required. Among other matters, these super majority actions may include whether to sell the business, to buy a business, to enter contracts with affiliates of either party, to terminate a service line, to alter the charity care policy, to borrow money in excess of specified amount, to approve a budget, or to adopt a strategic plan.

Whether in an equal governance or super majority model, the AMC and its partner often address how they will resolve disagreements on such matters. Arbitrating such disputes is frequently suggested. Arbitration, however, generally is not a workable solution since there is no "right" answer to whether the joint venture should, for example, enter a new service line. Mediation is a much better approach. Although the joint venture may engage a trained professional to assist in the mediation process, incurring such expenses is often unnecessary and may even run counter to the "partnership" concept. In the event that there are matters that are important but not highly critical to the underlying purposes of the collaboration, including an "informal" mediation provision in the formation documents when first establishing the joint venture can be helpful. For example, requiring the chief executive officers of both partners to discuss and attempt to resolve an issue encourages their subordinates to be reasonable and seek alternatives. Who wants to tell their ultimate boss that she could not come to a reasonable solution to an issue with their partner? That may be a career-limiting opportunity.

In the event that the parties are unable to resolve their disagreement, two alternatives are frequently explored. If the disagreement concerns a material issue that goes to the core of why the parties originally formed the joint venture, the disagreement may trigger the right of one party to buy out the equity interests of the other. Alternatively, the status quo may be maintained—i.e., if a course of action is not approved by both parties, both have to proceed without it.

Planning for the End at the Beginning

How and when a joint venture is dismantled is an important issue to consider when the entity is formed. In addition to rights of first refusal with respect to a party's proposed sale

of its equity interest to a third party, it is not unusual for the definitive agreements to grant one party the ability to “call” the equity interests of the other party under certain circumstances. Similarly, the agreements may grant one party the right to “put” its interest to the other. Common triggers of these types of rights include the passage of time, breach of the agreement, change in control of a party, or deadlock.

Perhaps one of the most equitable approaches to disagreement over core issues is often referred to as a “shotgun” provision. This approach allows a party to offer to buy the other party’s units at a specified price. If the other party does not wish to sell at that price, it has the right to buy out the other at that same price.

In some circumstances, the mission of the AMC and its market position may be such that it will never want to be the “seller.” The scope of the rest of its enterprise that is not part of the joint venture may be so vast that it would not want to help create a competitor in the marketplace should the AMC have its interests acquired by its partner.

In determining the price at which buy-out rights are exercised, the parties often agree to use a third-party appraisal of the “fair market value” (FMV) of the interests. Whether the FMV amount is subject to a minority discount or determined net of the enterprise’s debt are frequent points of contention that will need to be addressed.

Similarly, whether a floor or ceiling is imposed also can be subject to negotiation. For example, the AMC may wish to “lock in” the lowest price at which a sale would occur equal to the valuation of the enterprise when the joint venture was formed. Conversely, it may wish to establish a ceiling (such as 7x Earnings Before Interest, Taxes, Depreciation, and Amortization) so that it can set aside the capital necessary to exercise its right to buy out its partner.

It is important to keep in mind that if one of the reasons why the AMC entered the joint venture was to gain better access to capital, its buy-out rights could be illusory if the AMC cannot or is not willing to deploy its capital to buy out its partner.

Keep Your Friends Close . . .

Many joint venture agreements contain non-compete provisions to ensure that the parties’ interests remain aligned towards the success of the joint venture. It is common that such provisions apply both during the period a party owns an equity interest and for some period of time thereafter. The rationale for the “tail” period is simply fairness: it would be unfair for a party to use the proceeds received from selling its interests to compete with the (former) joint venture.

The scope of the restricted activities is crucial and should align with the reasons why the joint venture was created. If one of the goals of the joint venture is to acquire and operate certain hospitals or ancillary businesses in a specified geographic area, the partners generally should not be able to do those same things in that specified region. These provisions are often heavily negotiated by AMCs that are concerned with any limits on their ability to fulfill their academic and healing missions. Special attention is also paid to how existing business operations of the AMC or its partner that are not contributed to the joint venture are operated within the geographic area.

That Thing You Do

Many AMCs possess considerable expertise in one or more service lines that could enhance the operations of the joint venture. Whether the joint venture should be obligated to use those service lines on an exclusive basis and what price will be paid by the joint venture for such services are often the subject of negotiation. If the joint venture is required to use those service lines, may it cease doing so if it determines that better or equal quality assistance can be obtained from a third party at a lower cost? Since the AMC owns a portion of the joint venture, the parties also frequently consider whether the form of agreement that the AMC would use with a third party should be modified for use with the joint venture.

Yours, Mine, and Ours

AMCs are frequently concerned with the identity and qualifications of their faculty. The research and teaching elements of practicing in a AMC setting are simply different than practicing in a traditional community hospital setting. Still, the AMC looks towards the revenues produced by its faculty practice plan to help defray the costs of employing the faculty physicians and to support the academic mission. These realities, unique to the AMC, lead to important negotiations concerning whether the physicians hired by the joint venture should in fact be employed by the AMC’s faculty practice plan. Much like the service line issues described above, whether the faculty practice plan of the AMC will be the exclusive provider of certain types of additional physician services—and if so, at what cost—are key issues to address when forming the joint venture.


Antitrust Concerns

Often overlooked, the potential antitrust implications of joint ventures with AMCs should be taken into consideration when forming the joint venture. Antitrust issues arise in the joint venture context in the event that the AMC and the other party currently compete against each other and/or one of the

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parties “competes” with the joint venture, whether for patients, employees, or otherwise. If so, the parties may need to address how competitively sensitive information—e.g., strategic plans, wages, and payer contracts—is handled and how competitively sensitive decisions are made. Many joint ventures between AMCs and investor-owned companies involve the for-profit partner entering a new market. In these instances, antitrust concerns are minimized for the investor-owned partner but still exist for the AMC in the event that it is not able to own a majority of the equity interests in the joint venture. Moreover, even where the AMC is the majority owner, market concentration issues may arise if the joint venture seeks to acquire additional assets in the geographic market of the AMC. Special antitrust counsel may be needed to craft structural means to address and minimize the impact of antitrust issues.

The Road Ahead

The growing number of AMCs and other tax-exempt organizations entering into innovative partnerships with investor-owned companies shows that health care providers are increasingly willing to explore new avenues for providing care within the communities they serve. As the health care industry continues to adjust to an evolving post-reform marketplace and heightened economic pressures, the trend is likely to continue. As organizations seek to blend divergent cultures into a shared mission, however, it is important to understand the relative strengths that each party brings to the new venture and approach the partnership as a true collaboration that will require degrees of compromise from all sides. 

Thanks go to the leaders of the Teaching Hospitals and Academic Medical Centers Practice Group for this month's feature: **Dawn R. Crumel**, Vice President and General Counsel, Meritus Health, Hagerstown, MD (Chair); **Claire Cowart Haltom**, Baker Donelson Bearman Caldwell & Berkowitz PC, Nashville, TN (Vice Chair of Publications); **Auburn K. Daily**, Principal Counsel - Health Law, Office of General Counsel, University of California, Oakland, CA (Vice Chair of Research and Website); **Harold W. Jordan**, McKesson Technologies Inc., Alpharetta, GA (Vice Chair of Membership); **Andrea M. Kahn-Kothmann**, Office of University Counsel, Thomas Jefferson University, Philadelphia, PA (Vice Chair of Educational Programs); and **Gelvina Rodriguez Stevenson**, Eisai Inc., Woodcliff Lake, NJ (Vice Chair of Strategic Activities).

For more information about the Teaching Hospitals and Academic Medical Centers Practice Group, visit www.healthlawyers.org/pgs or follow them on Twitter @AHLA_TH_AMCs.

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Endnotes

- 1 Duke University Health System and LifePoint Hospitals Partner to Create Innovative Options for Community Hospitals, available at www.dukehealth.org/health_library/news/duke-university-health-system-and-lifepoint-hospitals-partner-to-create-innovative-options-for-community-hospitals.
- 2 Shands partners with HMA to run 3 rural hospitals, available at <http://www.gainesville.com/article/20100527/ARTICLES/100529503>.