

## FEATURE STORY

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## something old is something new again structuring physician practice acquisitions

The trend toward acquisition of physician groups is accelerating as changes in law, reimbursement pressures, physician shortages, and changes in care delivery force hospitals to rethink their physician integration strategies.

### AT A GLANCE

A physician employment contract should give careful consideration to:

- > Hours of practice
- > Control that can be exercised by the hospital
- > The ability of the hospital to relocate the physician's practice
- > Compensation formulas and benefits
- > Covenants not to compete

The acquisition of physician practices by hospitals and health systems—once thought to be a thing of the past—has returned with gusto. Hospitals with cash and a desire to recapture lost revenues and lock in future referral streams are expressing renewed interest in such acquisitions, while physicians—often strapped for capital, overleveraged, and facing declining incomes due to pricing pressures and reduced prospects for ancillary revenue—are, again, finding hospital employment attractive.

Today's physician practice acquisition deals are bigger, more complex, and riskier than the transactions that took place during the 1990s. It's important for healthcare organizations to understand this trend: what is occurring, why, and how buyers and sellers can structure, plan for, and execute these deals successfully.

### What Is Going on Out There?

A number of large physician practice acquisition deals have made headlines in the past couple of years:

- > In summer 2007, Aurora Health Care of Milwaukee announced its affiliation with Advanced Health Care, a 250+ physician multispecialty group practice with locations throughout Milwaukee and southeastern Wisconsin.
- > Also that summer, Banner Health acquired Arizona Medical Clinic, an 80-person multispecialty group near Phoenix.
- > In January 2008, Fairview Health Services in Minneapolis acquired 87-physician Columbia Park Medical Group.
- > Also in January 2008, Medical Associates, a specialist-heavy group in suburban Milwaukee, agreed to affiliate with Pro Health Care, a suburban Milwaukee-based system.

## FEATURE STORY

What did these deals have in common? They all involved the acquisition of complex multispecialty physician groups by regional hospital systems. The nonpublic nature of the transactions often makes details difficult to analyze, but in general, they likely shared some of the following characteristics seen in most practice acquisitions:

- > The physicians were offered employment arrangements that included production-based compensation formulas and incentives to align physician and hospital interests.
- > The practices were valued by one or more independent, third-party valuation firms to support or determine purchase price.
- > Significant practice value was derived from ancillary services, such as imaging, lab, ambulatory surgery, sleep studies, and clinical research.
- > In some instances, intangibles, such as large assembled work forces, contributed value.
- > The physicians and the hospitals agreed to structures that will provide the physicians with an ongoing role in group governance and management.
- > The size of the groups, the profitability of the ancillary business lines, and the value of the tangible and intangible assets represented material investments by the hospital buyers with significant strategic implications for their businesses.

### What's Driving This Trend?

There is no single reason to account for the recent increase in transaction volume. Rather, a confluence of economic and regulatory circumstances have dramatically changed the business environment for hospitals and physicians.

**Changes in law.** Changes in the federal and state regulatory environment clearly have had an impact on this trend. In the 1990s, joint ventures, such as shared services facilities, block leases, turnkey management structures, and “under arrangements” deals, had become commonplace. Structures such as these allowed physicians and hospitals to share in, rather than compete for, ancillary income streams.

## Today's hospital leaders are taking a much more strategic approach to physician practice acquisitions.

Beginning in late 2007, however, the Centers for Medicare & Medicaid Services and the Office of Inspector General made sweeping changes to the Stark law and other rules—changes that not only stemmed the tide of new deals, but also required the restructuring or termination of joint ventures already in place. As a result, physicians and hospitals once again find themselves competing for revenue from ancillary income streams.

**Capital constraints.** The desire by physicians to capture ancillary income over the past decade spawned large capital expenditures in equipment and facilities that, in many markets, created excess capacity. As years passed, equipment and facilities owned by physicians became outdated, and many physician groups—bereft of capital and highly leveraged—delayed reinvestment, resulting in reductions of cash flow from previously profitable businesses. Despite increased capital needs, the recent credit crunch has exacerbated the lack of access to capital for most physician groups.

**Reimbursement pressures.** Changes in Medicare are driving down the profitability of physician practices and other arrangements, while managed care companies continue to take advantage of the market consolidation over the past decade. In many markets, payers have used the bargaining leverage gained from consolidation to extract significant concessions from physicians.

**Physician shortages.** The acquisition of physician practices has become a strategic imperative for many hospital systems to address medical staff shortages. The Bureau of Labor Statistics predicts that there will be 212,000 physician openings by 2014—a number equal to more than 25 percent of

the current physician work force. In some states with high numbers of retirees, such as Arizona and Florida, acute physician shortages are already the norm.

### How to Avoid Past Mistakes

The physician practice acquisition craze of the 1990s was unsuccessful for many hospitals. Hospitals were notorious for overpaying for practices, putting physicians on salary guarantees, and then failing to actively and carefully manage acquired practices. This typically resulted in huge losses and unproductive, ultimately unhappy physicians. In many instances, the practices were resold to their original physician owners, usually at a substantial discount to the original acquisition price.

Today's hospital leaders are taking a much more strategic approach to these transactions. Likewise, physician executives are making certain that physician practice acquisitions thoughtfully by aligning physician and hospital incentives, give due regard to fair market value, ensure a certain level of physician practice autonomy, and provide a voice for physicians in governance and management. As a result, these transactions often are hotly negotiated and heavily scrutinized.

The size and complexity of these transactions has increased the need for third-party opinions.

For example, in the past, the question of valuation was traditionally determined by buyers anxious to placate their physician partners—and often, purchase prices were not supported by third-party valuations. Today, valuations have become a staple of physician/hospital relationships. The concept of fair market value pervades almost every important legal principle applicable to these transactions.

In addition, physicians often have high expectations for the value of their practices. They recognize not only the value of the professional and technical fees generated in their practices, but also recognize and seek value for the referrals and increased reimbursement for physician services

they will bring to the acquiring hospital. Gaps in expectations can create challenges for hospital acquirers who are prohibited from paying for referrals or for the value that the hospital brings to the table by reason of its market position. As a result, care must be taken when establishing the value of a physician practice. The value of physician practice assets will be constrained by the expected cash flow generated from these assets *after* physician compensation is paid. To the extent physician compensation remains the same or even increases after an acquisition, expected cash flow to the hospital will be limited; as a result, the value of the practice will be limited as well.

As the above discussion illustrates, a credible valuation is critical to any deal.

Given today's constrained capital and credit markets, many hospital boards are obtaining fairness opinions from independent financial advisers, such as investment banks, when evaluating transactions that will require considerable capital to execute. These opinions provide hospital boards with needed "cover" from claims that an acquisition transaction is unfair to the hospital or its creditors and, further, support board members' exercise of sound business judgment in analyzing and approving a deal.

### Managing Physician Expectations

Physician practice acquisitions are as much about physician emotions and expectations as they are about deal points. One key to managing physician expectations is to develop an understanding of those expectations. Managing expectations includes communicating critical deal points early and often. One element of the deal that should be discussed and negotiated with the physicians very early in the process is the physician employment contract.

A physician employment contract provides each physician with an outline of what his or her professional life is going to be like post-transaction. In many cases, the contract will likely be longer, more detailed, and, sometimes, more heavy handed than that to which the physician is

## FEATURE STORY

accustomed. Careful consideration should be paid to items such as:

- > Hours of practice
- > Control that can be exercised by the hospital
- > The ability of the hospital to relocate the physician's practice
- > Compensation formulas and benefits (such as paid continuing medical education and vacation)
- > Covenants not to compete

Although a physician group will usually engage "lead" counsel who will negotiate the terms of the employment contract template with the hospital, it is wise to offer rank-and-file members of the practice the ability to have their own counsel/tax advisers review the agreement as well. An education session also is a very valuable tool for answering questions and alleviating physician concerns. One of the lessons learned from the previous practice acquisition wave was that divorcing physician compensation from productivity and hospital objectives was a prescription for failure. In previous versions of these transactions, physicians were given guaranteed salaries, which usually led to unproductive—and ultimately

unhappy—physicians. Today's dealmakers are advised to spend time and money up front to structure compensation arrangements that link compensation with productivity, quality, and other objectives important to the hospital.

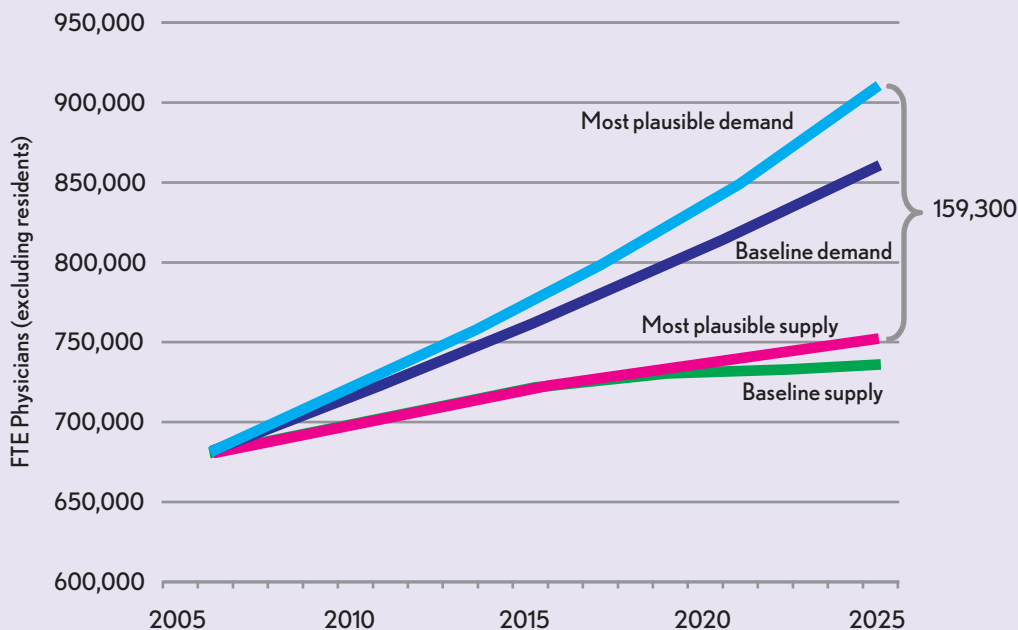
Often, we see compensation structures built around a number of elements, some of which are financial and others that meet quality, work environment, and patient satisfaction objectives and often include:

- > Productivity (either through resource-based relative value units or revenue)
- > Collections
- > Clinical efficiency
- > Integration efforts
- > Quality/safety/patient satisfaction
- > Income from ancillary activities
- > Good citizenship

Establishing a compensation structure early in the acquisition process avoids a number of problems and provides a number of benefits:

- > The compensation structure is critical to developing a business plan grounded in realistic

### PROJECTED FTE PHYSICIANS, MOST PLAUSIBLE SCENARIO, 2006-25



Source: The Association of American Medical Colleges. Used with permission.

financial assumptions that helps set expectations and measures the impact of decisions made during the negotiations.

- > Physicians have to be willing to tie their compensation to hospital objectives.
- > Future compensation can have an impact on the valuation of the acquired practice.
- > Establishing a fair compensation structure up front can serve as motivation to complete the transaction.
- > The process of developing the compensation plan provides physicians with insight regarding the tax and regulatory restrictions placed upon them when they become part of hospital systems.

### Physicians and Governance

Among the more difficult elements to structure in a practice acquisition are the terms under which physicians retain a voice in how they govern and manage themselves. Many of the physicians who will become hospital employees have never worked for anyone other than physicians, and some of them will have had governance and leadership positions within their organizations. These physicians may balk at the idea that they no longer have a voice in governance and management. Failure to allow physicians a meaningful voice in governance can kill a deal or eventually lead to significant dissatisfaction among valuable group members. However, the decision to allow physicians a voice should be balanced with the need of the hospital to protect and maintain its tax-exempt status and run its operations efficiently.

Areas where a hospital is likely to receive significant input regarding physician governance typically involve clinical issues, such as quality, utilization review, patient satisfaction, and research; physician and clinical employee discipline (including, in certain instances, hiring and firing decisions); compensation allocation (within legal constraints); capital prioritization; and resource utilization, such as supplies, staff, and equipment.

### Legal Issues

Both the acquisition of physician practices and the employment of physicians are fraught with

legal issues. Among key elements that must be considered are:

- > Transaction structure (e.g., equity versus asset purchases)
- > Physician tax considerations (i.e., single versus double taxation)
- > Structuring purchase price
- > Regulatory approvals (poorly timed approvals can slow down a transaction)
- > Due diligence (helps to avoid unfortunate surprises)
- > Market terms (physicians are expected to represent the status of their business)
- > Escrows and indemnities (protects the integrity of the purchase price paid)

### Careful Structuring Protects Value

Acquisitions of large, complex physician groups is a significant trend that will accelerate as changes in law, reimbursement pressures, physician shortages, and structural changes in how care is delivered force hospitals to rethink their traditional physician integration strategies. These complex transactions require identification and consideration of a multitude of variables. Managing these variables effectively will ensure the successful conclusion of a transaction. Structured correctly, these deals can ensure that long-term value is created from an acquisition effort. ●

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