

## **SELLING YOUR PRACTICE: to an integrated delivery system**

By: Jeremy N. Miller, J.D.

CALIFORNIA PHYSICIANS WHO ARE considering whether to sell their practices to and join an integrated delivery system (IDS) face complex decisions. IDSs, which are generally hospital sponsored, include management services organizations (MSOs), physician hospital organizations (PHOs), and tax-exempt “foundations.”

Unless a physician is nearing retirement, determining whether to sell a practice to an IDS is more akin to deciding whether to join a new medical group than it is to a traditional practice sale. This is because the selling physician expects to continue to practice after the sale, rather than retire. Physicians are often enticed to join an IDS by the promise of maximizing their practice’s sales price. Except for those close to retirement, this is not, however; of primary importance.

Rather physicians should try to maximize three things: net income during the next 10 or more years; control; and freedom to pursue other avenues if the IDS proves unsuccessful. From this broader perspective, promises of increased access to managed care contracts, capital, and professional management services come into focus as the means to the hoped-for end of maximizing professional autonomy and income.

PHYSICIANS MUST BE AWARE of the price they might have to pay to obtain the benefits of joining an IDS. Among the questions they should ask are:

- ! Do I need the hospital’s money to achieve my practice goals, and, if so, how much?
- ! Is the hospital the only or best source of such funds?
- ! Will I end up repaying some or all of the money to the hospital, such as through management fees?
- ! What controls or other concessions will the hospital demand for its money?

Physicians should not underestimate their bargaining strength *vis à vis* the hospital. Generally, it is hospitals that need to be linked up with physicians to earn a seat at the managed care table.

From the very start, physicians should retain their own, independent legal and financial advisors to guide them through the complex process of joining an IDS. Too often physicians rely solely upon the hospital’s advisors for crucial legal and financial advice. It is a mistake to assume that hospital-paid attorneys, no matter how well-meaning, can fairly, and aggressively, represent physicians’ interests as well. Attorneys and financial advisors can help physicians analyze several basic considerations.

## WHO IS THE BUYER?

Will the physician's practice be purchased by a hospital-sponsored MSO, foundation, or by a medical group that will be an IDS component? Is the hospital tax-exempt or for-profit? Because of the prohibitions against the corporate practice of medicine, private inurement, and kickbacks (discussed later) the purchaser's identity can have a significant impact on the purchase terms.

## WHAT IS BEING PURCHASED?

Is the physician selling his or her tangible assets (such as furniture, fixtures, and equipment) or stock (assuming the physician is professionally incorporated)? A PHO, MSO, or foundation cannot purchase a professional medical corporation's stock. The stock can only be sold to another professional medical entity. Purchasers generally prefer to buy assets rather than stock to avoid assuming the selling physician's liabilities. Whether physicians should sell accounts receivable can be a tricky issue, in part, because of the problem of valuing receivables. In some cases, the receivables are not sold; in others, physicians are required to turn them over to help finance the IDS's start-up costs. Finally, will the physician be paid anything for goodwill (discussed later)?

If a number of medical practices will be consolidated in connection with formation of the IDS, the purchaser might not want to buy all of the physician's furniture, equipment, and other tangible assets. And unless they are paid fairly for them, it might not be in the physician's best interests to sell accounts receivable. Furthermore, physicians should ask if the purchaser assumes such liabilities as office and equipment leases or practice loans.

If the selling physician's current professional liability carrier is not the same as the company that the IDS uses, the physician might have to purchase a "tail" or "nose" policy. Such a policy protects the physician if a lawsuit is filed after the practice sale for malpractice alleged to have occurred before the sale. If possible, the selling physician should require that the purchaser pay for the tail or nose, which can be a significant expense.

## WHAT IS THE PURCHASE PRICE?

The value of most medical practices, and those of specialists in particular, has dropped significantly during the past few years, in large part because of managed care's impact. Physicians are often lured to join an IDS by the prospect of receiving a premium price for their practices, and, in fact, this may be possible in some cases. On the other hand, hospitals that are tax-exempt might have inurement problems, as well as fraud-and-abuse concerns, that prevent them from paying more than fair market value for a physician's practice.

The prohibition on private inurement means that tax-exempt hospitals cannot permit any of their profits to accrue to the benefit of private individuals in a position to control the hospital, and the hospitals must be operated to serve public rather than private interests. The Medicare-Medicaid anti-fraud-and-abuse amendments make it illegal for any hospital (either for-profit or tax-exempt), person, or entity to pay any remuneration to a physician in exchange for or to induce patient referrals. When physicians sell their practices to an IDS, both private inurement and fraud-and-abuse issues can arise

if: a hospital is paying more than fair market value for tangible practice assets; a hospital pays for goodwill; or certain items and services (such as office space, equipment, and management services) are provided to physicians at below fair market value rates. The Internal Revenue Service has indicated in several rulings that hospitals can pay for goodwill among other intangible assets (although this might not be possible in California because of the corporate practice of medicine bar). However, the U.S. Department of Health and Human Services' Office of Inspector General considers that payments for intangible assets such as goodwill and restrictive covenants are suspect and could be viewed as disguised compensation for patient referrals.

Although the complicated subject of valuing a medical practice goes beyond the scope of this article, physicians should be familiar with several, general valuation concepts. First, a medical practice's price is usually a combination of the value of the tangible assets, accounts receivable (if sold), and the practice's "goodwill." Tangible assets, such as equipment and furniture, can be valued at their original cost, at "book" or depreciated value, or at fair market or replacement value.

Determining goodwill is much more difficult. Goodwill refers to a medical practice's "going concern" value. This generally means the selling physician's ability to transfer to the purchaser the practice's reputation, patients, and earnings stream. Among the methods that medical financial experts use to determine goodwill are discounted percentage of net cash flow, capitalization of the practice's net earnings in excess of those of the average physician in that specialty and geographic area, and recent sales of comparable practices, if any have occurred. If the selling physician continues in practice after the sale, arguably, the purchaser should not pay anything for goodwill, because the physician continues to benefit from it. Some parties try to sidestep the goodwill valuation problem by agreeing that the purchaser pays the selling physician a percentage of the post-sale collections or net profits. However, this can constitute fee-splitting or a kickback that violates California or federal laws.

#### HOW WILL THE PURCHASE PRICE BE PAID?

Will the purchase price be paid in a lump sum, or as is more commonly the case, partly in a cash down payment, with the balance paid over time pursuant to a promissory note from the IDS? If there is a promissory note, over how many months or years does the purchaser pay, and what is the interest rate?

Physicians often want the purchase price paid as soon as possible, unless there are tax or other reasons to spread the income. If the physician takes back a promissory note, the note should be adequately secured by the tangible assets sold and, if possible, by the purchaser's accounts receivable. In some cases, physicians might be expected to sell their practice in exchange for stock in the IDS. Please note, however; if the IDS goes bankrupt, the stock could become worthless.

## RESTRICTIVE COVENANTS

Selling physicians could face two types of restrictive covenants: one requires the physician (particularly primary care physicians) to practice exclusively through the IDS; and a second provides that if the physician were to leave the IDS, he or she could not practice within a designated service area for a number of years. Because physicians need to retain flexibility in the event the IDS is unsuccessful, they must determine whether the benefits of joining the IDS justify such restrictions.

## RETIREMENT PLANS

IRS rules generally require that all physicians participating in an IDS either be covered under the same retirement plan or have no plan at all. Thus, a physician selling to an IDS might be required to terminate his or her existing plan. If so, plan termination can accelerate the vesting of benefits for existing plan participants. On the other hand, a physician who did not have a plan before could now be required to participate in one through the IDS.

## 'FOUNDATION' STATUS REQUIREMENTS

If physicians sell their practices to a hospital-sponsored, tax-exempt foundation, they could be saddled with numerous restrictions and conditions under California law and IRS rules, including:

- ! requirements that the physicians accept Medicare, Medi-Cal, and uninsured patients requiring urgent care
- ! significant medical research and education requirements
- ! an obligation to seek out Medicare and Medi-Cal managed care contracts
- ! severe limitations on physician control of the foundation's board of directors and on physician input in determining physician compensation.

## POST-SALE MANAGEMENT SERVICES AGREEMENT

In most IDS arrangements, after selling their practices, physicians enter into a long-term management services agreement (MSA) with their new hospital partner. The MSA terms can be more important than the terms of the practice sale. Among the issues physicians need to consider are:

- ! Precisely what services will be provided pursuant to the MSA?
- ! How much will the physicians be charged for these services?
- ! Will the physicians retain control (as they should) over all clinical matters?

Physicians should also retain ultimate control over selection and retention of the IDS's chief executive officer. Other key issues include the length of the MSA's term and under what circumstances it can be terminated. Finally, physicians need to have the power to terminate the MSA if the relationship proves unsatisfactory.

## TERMINATING THE RELATIONSHIP

Before selling their practices to an IDS, physicians need to have a contingency plan if they later want to leave the IDS. As mentioned before, physicians should try to limit post-termination restrictive covenants. In addition, they should negotiate for the option to buy back their practice assets, including office leases, equipment, medical and business records, and related computer software and hardware. There is a risk, however; that physicians might not be able to recover managed care contracts and patients that they had before joining the IDS.

Joining an IDS is an option worth physicians' consideration, but they must proceed very carefully to ensure that their interests-to control their medical practice, earn a decent income, and retain freedom to pursue other options if necessary-are protected. With effective, independent advisors' assistance from the start, physicians will greatly increase the likelihood that the IDS will help them achieve their practice goals.

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