Presenting a live 90-minute webinar with interactive Q&A

Joint Operating Agreements in Healthcare
Complying With Regulatory Requirements and Maintaining Tax-Exempt Status in Structuring Virtual Merger Arrangements

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1pm Eastern    |    12pm Central    |   11am Mountain    |    10am Pacific

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JOINT OPERATING AGREEMENTS
IN HEALTHCARE

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Presentation Outline

• Drivers Behind Community Hospital Strategic Relationships
• Legal Considerations Related to Community Hospital Transactions and Discussion of Structural Options
• Structuring Joint Operating Companies
• Tax Issues
• Antitrust Issues
• Regulatory Issues and Approvals
• Due Diligence Considerations from Buyer and Seller Perspectives
• Completing the Deal Structure from Letter of Intent to Full Integration
What Are Community Hospitals facing?

- Capital Constraints
- Shortage of Physicians and Healthcare Professionals
- Growing IT Infrastructure Requirements
- Integration of Healthcare Providers
- Healthcare Reform/Regulatory Uncertainty
- Decline in Admissions

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Major Pressures on the Health System

• Credit Rating Requirements
• Employed Physician Losses
• Uncertainty about reimbursement
• Health Insurance Exchange
• No Medicaid Expansion

• Operating Costs
  • Capital Requirements
  • ICD-10
  • Price Transparency
  • Payer Mix Change
Hospital Acquisition and Consolidation Models

- Clinical Affiliations
- Facility Management Agreements
- Joint Operating Companies
- Long Term Leases
- Nonprofit Mergers and Member Substitutions
- Asset Purchase Agreements
- Stock Purchase Agreements
Changing Landscape

Degree of Integration

Affiliation
- Management Services Agreement
- Agreement

Emerging Structures
- Joint Venture
- Sale of Minority Interest
- Joint Operating Agreement
- Sale of Controlling Interest

Traditional For-Profit Transaction Structure
- Merger
- Change of Corporate Member

Low
High

High
Low
Examples of Minority Interest Joint Ventures

Minority Interest Joint Ventures

- University of Washington
- University of Michigan Health System
- Duke Medicine
- Fred Hutchinson Cancer Research Center
- MidMichigan Health
- Seattle Children's Hospital

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Alternative Models of Collaboration

Collaborative Purchasing and “Best Practice”

Management Services Agreement

Joint Operating Agreement
Assessing the Need for the Joint Venture

• Financial Considerations
• Strategic Considerations
• Importance of Mission
• Board fiduciary duties including duty of care and duty of loyalty
• Document decision process carefully
• Engage consultants, financial advisors and legal counsel at the outset
• Keep stakeholders informed
Joint Operating Company

• A “JOC” is a legal structure that allows the joint operation of services and business activities among hospitals that are not jointly owned.

• A Joint Operating Agreement or “JOA” allows participating hospitals to retain separate boards of directors, but turn over management functions to a separate entity.
Joint Operating Company, Cont’d

• A JOC is formed according to the terms of a JOA, which is the formal legal agreement defining the terms of combined operations
• Sometimes referred to as a virtual merger
• May be used to integrate operations without actually transferring assets
• Agreement sets forth financial relationships of the parties and distribution of profits and losses
Long-Term Facility/Operations Leases

• Long-term lease (e.g., 20+ years)
• Lessee takes control and is responsible for all operations, revenues, and expenses (e.g., capital expenditures, physical plan maintenance)
• Lessee makes lease payments to lessor
• Majority of these models are between a municipality/government entity and a for profit or nonprofit system
• At the end of the lease term, hospital control reverts to lessor
Nonprofit Mergers & Membership Substitutions

• Brings together two or more hospitals/health systems, combining assets and liabilities (may be separated by facility or region)

• Generally cashless transactions (future capital commitments/other funding requirements/assumption of liabilities common)

• Goal of strong integration; shared contracting; economies of scale
For Profit Stock or Asset Deals

For Profit to For Profit Transactions

• The purchaser buys the seller’s hospital and physical assets through stock or asset purchase

• In an asset deal, the seller repays non-assumed debt and liabilities

• In a stock deal, buyer accepts assets and liabilities, stepping into shoes of seller(s)
Federal Income Tax Exemption Issues
What's The IRS Got To Do With it?

- Section 501(c)(3) tax-exempt organizations must operate for exempt purposes.
- 501(c)(3) organizations can endanger their exemption if they conduct a trade or business unrelated to exempt purposes ("UBI") as a substantial part of their activities.
- 501(c)(3) organizations can't share profits with non-exempt entities or provide an equity-type interest to non-exempt entities.
- With very limited exceptions, tax-exempt bond-financed property can't be used, occupied, or owned by non-exempt entities.
  - Or by tax-exempt organizations in UBI activities.
Why do they care about control?

- "Actual" hospital merger
  - Hospitals are brought together under common tax-exempt parent
  - Parent exercises structural control through director appointment and reserved powers
  - Related organizations are an "integral part" of each other and can share services and management without UBI

- A JOA often doesn't have this type of structural control

- Because of JOA bottom line sharing, IRS could view a non-exempt JOC as having equity-type interest in each participating system, or as exempt assets being used in an unrelated trade or business
Joint Operating Company
Delegated Hospital Board Selection

Parent A

Joint Operating Company*

Appoint JOC directors
Reserve powers over
JOC organic changes

Joint Operating Company*

Appoint directors and exercise reserve powers

Hospital A1**
Hospital A2
Hospital B1
Hospital B2

Parent B

* JOC board makes decisions for hospitals as their parent; supermajority requirements, but not class voting, permitted
** Each hospital retains its license, governing board, and assets
Joint Operating Company
Parents Retain Board Selection

- **Parent A**
  - Appoint JOC directors
  - Reserve powers over JOC organic changes
  - Appoint hospital directors
  - Reserve powers over hospital organic changes
  - Hospital A1**

- **Parent B**
  - Appoint hospital directors
  - Reserve powers over hospital organic changes
  - Hospital B1
  - Hospital B2

- **Joint Operating Company***
  - Exercise reserve powers

* JOC board makes decisions for hospitals as their parent; supermajority requirements, but not class voting, permitted
** Each hospital retains its license, governing board, and assets
Tax Exemption for JOCs

- Obtaining tax exemption for JOC is key to avoiding UBI and private use
- The IRS examines four factors to determine whether JOC has equivalent of parent-subsidiary relationship with the participating hospitals and is eligible for tax exemption
- Facts and circumstances analysis, based on IRS private letter rulings and training materials
IRS Factor 1: Delegation of Significant Authority over Participating Entities

• JOC should have power to, e.g.;
  – Establish budgets
  – Establish strategic plans
  – Approve debt
  – Reallocate income among entities (financial integration)
IRS Factor 2: Permanence

• A temporary relationship doesn't look like a parent-subsidiary relationship

• Is there glue to hold the parties together through disputes
  – E.g., arbitration or other dispute resolution

• Are there disincentives to voluntary termination
  – E.g., penalties for walking
IRS Factor 3: Veto Rights

- JOC exercises control, not just veto, over participants
  - Can initiate action, not just react
- JOC members have limited ability to veto JOC decisions
IRS Factor 4: Limited Reserved Powers

- Members have limited powers over JOC
- Only shareholder-type powers
- Member powers over JOC aren't exercised indirectly though class voting on JOC board
Joint Operating Company
Parents Retain Board Selection

- Parent A
  - Appoint JOC directors
  - Reserve powers over JOC organic changes
  - Appoint hospital directors
  - Reserve powers over hospital organic changes

- Parent B
  - Appoint hospital directors
  - Reserve powers over hospital organic changes

- Joint Operating Company*
  - exercise reserve powers

- Hospital A1**
- Hospital A2
- Hospital B1
- Hospital B2

* JOC board makes decisions for hospitals as their parent; supermajority requirements, but not class voting, permitted
** Each hospital retains its license, governing board, and assets
Partial System JOAs

- Affiliates not participating in JOA aren't integrated
- Services to them may be UBI
Joint Operating Company
Partial Hospital System Participation

- **Parent A**
  - Joint Operating Company
    - Appoint JOC directors
    - Reserve powers over JOC organic changes
  - Exercise all Parent powers
  - Appoint hospital directors
  - Reserve powers over hospital organic changes
  - Hospital A1**
  - Hospital A2***

- **Parent B**
  - Appoint hospital directors
  - Reserve powers over hospital organic changes
  - Joint Operating Company*
    - Appoint JOC directors
    - Reserve powers over JOC organic changes
  - Exercise
  - Reserve powers
  - Hospital B1***
  - Hospital B2

* JOC board makes decisions for hospitals as their parent; supermajority requirements, but not class voting, permitted
** May be unincorporated division of Parent
*** Each hospital retains its license, governing board, and assets
Is a tax-exempt JOC corporation absolutely necessary?

- Recent tax-exempt bond rule changes provide that a partnership with exclusively exempt partners can be a permitted user of tax-exempt bond-financed facilities.
- Option of forming an LLC with Parents A and B as members, providing the LLC with JOC powers, and not applying to IRS for recognition of exempt status.
- If the LLC has sufficient control, no UBI or effect on tax exemption or bonds.
- How to make this facts and circumstances determination yourself without precedential authority?
Antitrust Issues
Antitrust Issues Dovetail with Tax Exemption Issues

• In each case, the test is whether the parties have created a unity of economic interest through the JOA
Reason for Antitrust Concern

• If JOA members are competitors, their joint planning and pricing through the JOA is anti-competitive.

• Sherman Act Section 1 prohibits contracts, combinations and conspiracies between two or more parties that unreasonably restrain trade:
  – Such as price fixing
  – Such as market allocation

• Note that unity of economic interest doesn't help with Sherman Act Section 2 monopolization issues.
What is Unity of Economic Interest?

- *Copperweld Corp. v. Independence Tube*
  - Wholly owned subsidiaries can't conspire with parent

- As with tax exemption, the objective is to make the JOC akin to a parent and the hospitals in the JOA akin to subsidiaries
What is Unity of Economic Interest?

- Control over appointment and removal of directors and officers
- Control over hospitals' corporate documents
- Ability to operate and control the hospitals' assets and clinical programs subject to typical shareholder powers
- JOC control over JOA budget and strategic plan and those of hospitals
- Limited rights of members or hospitals to terminate, and it's hard to do so
  - FTC/DOJ guidelines suggest 10 years
- JOC can allocate profits and losses, assess capital contributions, and negotiate managed care contracts
Partial System JOAs

- As in tax exemption, the system parts not controlled by the JOC remain competitors of the JOC
Recent Antitrust Decision in 6th Circuit

- *The Medical Center at Elizabeth Place, LLC v. Atrium Health System*, 817 F.3d 934 (6th Cir. 2016)
  - Casts doubt on whether the “unity of economic interest” can be achieved in a JOA
  - But also points to some do’s and don'ts in forming a JOC that can withstand antitrust scrutiny
  - Case was dismissed *sub nom. The Medical Center at Elizabeth Place, LLC v. Premier Health Partners* on August 9, 2017 on other grounds in Southern District of Ohio
Recent Antitrust Decision in 6th Circuit

• Facts
  – Defendant Premier Health Partners is a longstanding JOA in Dayton, OH
  – Plaintiff is a new, small, physician-owned acute care hospital
  – Plaintiff alleged that defendant blocked plaintiff’s contracts with insurers and threatened medical staff physicians

• Lower court
  – Summary judgment based on defendant being a single economic actor
Recent Antitrust Decision in 6th Circuit

- Appellate decision
  - Summary judgment reversed
  - Plaintiffs presented evidence of continued competition between hospitals in JOA, thus creating genuine issue of material fact
  - Were there still “independent centers of decisionmaking” involving “potential competitors with distinct economic interests”?  
  - Answer: yes, based in part on consultant report where consultant was engaged to bring the system together and hospital personnel interviewed reported continued competition between facilities
Recent Antitrust Decision in 6th Circuit

• Dissent
  – Bottom-line sharing was central
  – Separate ownership of assets was in name only; owners did not derive any individual benefit
  – Centralized management and control over budgets and strategy
Lessons Learned

• In a JOA, walk the walk and talk the talk, on every level
• Don’t engage in overtly anticompetitive behavior even if you’re a single economic entity
Legal Hurdles & Regulatory Approvals

• Financing – Covenant Restrictions
• State Certificate of Need Laws
• Fraud and Abuse Concerns
• Reimbursement
• Attorney General Review
• Catholic Issues
• Health Care Compliance Issues
Financing Issues

• Contractual obligations common in financing documents
• Bond covenant restrictions can impede transaction or require significant debt restructuring
• Carefully assess financing/refinancing implications early on, as this may drive the ultimate structure of a transaction
Fraud and Abuse Concerns

Stark Law

• Stark prohibits physicians from referring patients for Medicare designated health services (DHS) to any entity with which the physician or her immediate family member has a financial relationship

• Financial Relationship covers a wide array of arrangements

• Designated Health Services (DHS)

• Can you fit within an exception?

• Strict Liability!

• Be very in tune with how the physicians’ compensation arrangements are set up in relation to this newly created joint venture
Anti-Kickback Statute

• AKS prohibits the knowing and willful offer, payment, solicitation or receipt of remuneration to induce or reward referrals of services reimbursable by a federal healthcare program
  • Even if one purpose of the arrangement is to induce referrals, it’s a violation
  • Specific intent is not required to be prosecuted under AKS

• Look at the relationship—are the parties in a position to make referrals to each other?
• Can you fall into a safe harbor?
Fraud and Abuse Concerns

FALSE CLAIMS ACT

• Any violation of Stark or AKS, by definition, also may be a violation of the FCA
• Actual damages (what the government paid but shouldn’t have) may be trebled, or tripled
• On top of actual damages will be civil penalties
• Possible exclusion from federal payer participation
• Potential criminal charges as well
Reimbursement

• How will you bill?
  • Create new joint venture provider numbers?
  • Or use one of the original entity’s provider numbers?

• Site of Service Restrictions
  • If the joint venture is providing services at a different location from the entity that is billing for the services

• Reimbursement status:
  • Provider-Based vs. Under Arrangements Services
State Attorney General Approval

Most states have statutes that require approval of the Attorney General for the disposition of a nonprofit corporation to a for-profit corporation and the statutes are often specific to hospitals because of their importance to the community.

- Examples include the Georgia Hospital Acquisition Act, O.C.G.A. §31-7-400 et seq.) and the Tennessee Public Benefit Hospital Sales and Conveyance Act of 2006, Chapter 930 of the Public Acts of 2006.

- Notice to Attorney General
- Public hearing is generally required
- Factors the Attorney General must consider, including access to care and cost of care, are set forth by statute or practice.

Attorney General approval should never be assumed.

- Tenet Healthcare withdrew its bid to buy 5 Connecticut Hospitals allegedly due to conditions placed on the transaction by State regulators.
- In California, Prime Healthcare backed out of a transaction with Daughters of Charity due to conditions placed on the transaction by Attorney General.
- Find out early how Attorney General has viewed similar transactions.
Important Steps in a Transaction

- Buyer assesses need
  - Board committee
  - Selection process (RFP, networking, etc.)
- Letter of Intent
- Due Diligence
- Definitive Agreement
- Approvals and Notifications
  - State licensing/CON
  - Attorney General approval
Letter of Intent

• Include the “big picture” issues such as capital projects, type of transaction, governance roles and consideration
• Assumed and Excluded Assets and Liabilities
• Employee matters and pension commitments
• Charity Care
• Use of Names
• Physician Recruitment/Medical Staff
• Exclusive Dealing
• Due Diligence/Access to Information
Due Diligence

• Extensive review of financial and operational compliance
• Licensure/CON
• Physician Agreements (Stark Law and Anti-Kickback issues)- may trigger need to self-disclose
• Termination fees/assignability of contracts
• Billing/Coding review
• Pending/Threatened litigation
• Cost Reports/Payor Audits
• Accreditation and licensure issues
Public Perception

• The parties should be “out-front” of any news of the joint venture

• If there’s a benefit to the community, the public perception will likely be very favorable
  • At the end of the day, the joint venture is still providing high-quality health care
  • But do keep up certain services and amounts of care, regardless of patient ability to pay

• To the citizen who looks, is the same hospital name still on the building

• Be aware, though, of your [brand], your intention for it, and its public perception