

BUYING AND SELLING MEDICAL PRACTICES

Medical practices can be acquired by other physicians in the practice, other physicians outside of the practice, larger group practices seeking to expand, hospitals, or physicians acquiring or re-acquiring their practices from a hospital. While the complexity of the transaction may vary with the size of the seller or buyer, certain issues must be addressed in all practice sales. This article will discuss issues for physicians to address as they consider the purchase or sale of a medical practice, and engage in related negotiations.

I. PURCHASE AND SALE PROCESS

A. Confidentiality Agreement/Letter of Intent. To begin the acquisition process, both parties to the sale often sign a confidentiality agreement. This agreement outlines the terms of the due diligence process and requires the information obtained to be kept confidential. Generally the agreement will include a deadline by which all due diligence must be completed, as well as details regarding the scope of the due diligence. The parties may also wish to include a standstill provision so that neither party will negotiate with anyone else for a specified period.

If the basic terms of the transaction have already been determined, the parties may instead execute a Letter of Intent. Typically, this is a basic outline of the proposed deal between the parties and will also describe matters of confidentiality and due diligence.

B. Form of Purchase. A practice acquisition may be of either a stock purchase or an asset purchase. It is important to note that with a stock purchase, the purchaser acquires assets (equipment, furnishings, and accounts receivable) as well as liabilities (payables, obligations to employees, malpractice actions). Acquisition of corporate stock is most prevalent when a current employee of the practice is becoming a full or partial owner of the practice and is thus legally eligible to own the stock and is prepared to assume all liabilities of the practice. Asset acquisitions are more common when a seller wishes to close a practice and retain accounts receivable, and a purchaser does not wish to be responsible for liabilities.

C. Purchase Price. The purchase price must be determined in accordance with fair market value in order to comply with regulatory requirements. Fair market value is the price resulting from bona fide bargaining between well-informed buyers and sellers on the date of purchase. Fair market value does not take into account the volume or value of referrals by the referring physician or other business generated between the parties.

The two types of assets of a practice requiring valuation are tangible (including furniture, equipment, and improvements) and intangible (goodwill). Tangible assets may be valued at book value or appraised separately if the parties believe there is substantial value to the tangible assets that warrants a third party appraisal or if there is disagreement about the valuation. Appraisal will also insure that the purchase price does not include payment for referrals.

Goodwill is an intangible element of a practice's valuation that is generally based on the practice's size, location, reputation, patient market, and profitability. Regulators have questioned the saleable nature of goodwill, particularly in situations where a physician sold the goodwill of his or her practice and maintained a continuing relationship with the purchaser. However, payment for goodwill has been found to be appropriate, as long as the amount paid is not in excess of the fair market value of the practice and does not take into account the value of existing or future referrals. It is important, however, that the valuation be determined using a recognized valuation methodology and supported by written documentation.

D. Purchase Agreement. Whether a stock sale or an asset sale, the controlling document is the Purchase Agreement which outlines all of the terms of the deal, and there are a number of issues which must be addressed.

1. Assets to be Included. If the entire practice is being sold, the acquired assets may include the following:

- current usable inventory and office supplies of the practice;
- telephone number, fax number and email address of the practice;
- patient lists of the seller;
- all general intangibles of the practice, including all good will in the business and all rights to any trade names, service marks and domain names
- seller's leasehold improvements.

2. Accounts Receivable. In an asset sale, accounts receivable of the seller are generally not an acquired asset. Rather, the seller retains the receivables and responsibility of their collection. When they are included, mechanisms to ensure the buyer's continued ability to collect those accounts should be secured. Additionally, the parties should address other professionally related income that may not be recorded as an account receivable of the seller, such as surpluses, administrative fees, and withholds owed to the seller by managed care payors that may be received by the buyer post-Closing.

3. Patient Records. As a part of the negotiations, the buyer and seller should determine how they will retain the patients' records after the sale, as well as the time frame for notifying patients of the transfer of the practice. The buyer and seller may choose to sign a Medical Records Agency Agreement for the retention of the patient records wherein the buyer covenants to keep and maintain the medical records of seller's former patients for the minimum period required by law. Under such an Agreement, the seller's obligations with respect to maintenance and access of medical records by patients are effectively assumed by the buyer.

4. Excluded Assets. Commonly excluded assets may include real property, cash, bank accounts, pension funds, insurance proceeds of the seller or cash value of any insurance policy, artwork and personal effects of seller's employees that are kept at the office. The excluded assets are customarily listed on a schedule. Sellers should review certain classes of assets such as benefit pension plans or prepaid expenses, which may affect the valuation and purchase price.

5. Liabilities. It is important to be specific about which liabilities the buyer will take on as a result of the purchase. Generally in an asset purchase arrangement, the buyer does not assume any liabilities or obligations of the seller except for those liabilities specified on a schedule. Such liabilities may include any continuing contracts that the buyer is assuming such as real estate or equipment leases, services agreements for equipment servicing, billing, staffing and janitorial services, and any vendor bills. All such contracts should be scrutinized to ensure that they can, in fact, be assigned to the buyer and will be so assigned by the Closing.

The agreement should also address expectations regarding the seller's employees, i.e., will they be guaranteed positions with the purchaser or will they be offered the opportunity to interview for a position. Note that in an asset sale, a purchaser will not be bound by a seller's employee benefits, such as accrued vacation or sick time, but in a stock sale, the purchaser would be obligated to address those benefits.

6. Purchase Price. The Purchase Agreement will include important terms regarding the total purchase price of the acquisition and the methodology used to reach that purchase price. The Agreement should include the amount of the purchase price as well as:

- the amount of any deposit;
- the amount of any closing payments;
- any adjustments to the purchase price;
- the exclusion of prepaid expenses existing as of the effective date from the purchase price. The Agreement may require the buyer to reimburse the seller for the cost of prepaid expenses, such as malpractice premiums, rent, and deposits; and
- the allocation of the purchase price among hard assets and intangible assets. Note that the allocation has tax implications for both buyer and seller, and must be negotiated to achieve a fair tax result for both sides.

7. Representations and Warranties. A key part of the Agreement is the buyer's and seller's Representations and Warranties, where the parties attest to such matters as their legal right to buy or sell the practice, that they are in legal good standing and have complied

with all laws and regulations, they have obtained all required approvals, paid all taxes, have no pending litigation or undisclosed liabilities. The purpose is to elicit information about the seller's business and give a foundation for recourse if undisclosed or unassumed problems later surface. Any exceptions to the Representations and Warranties will be listed in accompanying disclosure schedules, which also must be negotiated and agreed upon by the buyer and seller.

8. Rights and Obligations Subsequent to Closing. The Purchase Agreement will frequently include a provision requiring the seller to pay over to the buyer any amounts collected post closing related to the period prior to closing. In addition, if the seller will continue to have a relationship with the Purchaser following the Closing, it is important that this be documented in writing, often in a supplementary agreement. Examples include consulting or employment agreements between a selling physician and a purchaser, lease between a selling physician who may also own the real estate where the practice is located, and agreements regarding billing and collection of seller's accounts receivable.

9. Covenant Not to Compete. In cases where the seller will not have a continuing relationship with the buyer, a covenant not to compete will be an important item for negotiation. This becomes an issue in the purchase and sale of a medical practice because a seller may undermine the value of the practice by practicing in competition with the buyer following the closing thus diminishing the value of the practice just acquired. Restrictive covenants are generally enforceable only if they are reasonable in time and geographic area, and only to the extent necessary to reasonably protect a buyer's legitimate business interests.

Note that some state laws prohibit covenants not to compete in agreements with physicians, citing public policy which favors patients' access to physicians of their choice. As an alternative to a covenant not to compete, a buyer may insert a liquidated damages clause into an employment agreement in an attempt to prevent the selling physician from leaving the practice. Other methods a buyer might use to secure both the selling physician and his or her patients include:

- Lengthy employment agreements that can only be terminated by the physician for material breach;
- Establishment of deferred compensation, retirement or other benefit plans that vest over time in increments or at a specified future date, and with forfeiture of unvested benefits upon early termination of employment;
- Nonsolicitation covenants with respect to patients and employees;
- Longevity bonuses;
- Increasing vacation or other benefits over time; and
- Payment of claims-made tail coverage only if the physician is employed for a specified period

10. Indemnification. The indemnification provisions of the Agreement are critical to protect the buyer in the event the seller breaches any representations and warranties or covenants of the Agreement. A seller will be expected to indemnify and hold harmless the buyer from losses arising from the seller's misrepresentation or failure to disclose liabilities or conditions which ultimately give rise to costs to the buyer.

III. REGULATORY ISSUES

A. Fraud and Abuse. Buyers and sellers of medical practices need to be aware of fraud and abuse laws when structuring the acquisition. The principal issue in the purchase and sale of a practice is whether any part of the purchase price is in actuality a payment from the buyer for on-going referrals from the selling medical practice, or a discounted selling price to induce referrals from the buyer.

1. Antikickback. The Federal Antikickback Statute prohibits the knowing and willful solicitation, receipt, offer or payment of any remuneration, directly or indirectly, overtly or covertly, in cash or in kind, in return for referrals or in return for arranging, recommending, leasing or ordering of any item or service covered in whole or in part by Medicare or Medicaid. The Anti-Kickback Statute is a criminal statute, punishable by up to five years in prison and/or a \$25,000 fine, plus exclusion from Medicare and Medicaid programs. A prosecutor is likely to view any purchase price in excess of fair market value as a prohibited payment for referrals.

The Office of the Inspector General (“OIG”) has promulgated regulations containing safe harbors to the Antikickback Statute. Failure to comply with a safe harbor does not necessarily mean that the transaction violates the Statute. However, in order to qualify for any one of the relevant safe harbors, the remuneration must be at fair market value to alleviate any inference that the acquisition is being entered into to induce referrals.

There are two safe harbors for sales of practices: one that protects practitioner to practitioner transactions, and one that protects certain practitioner to hospital or other entity transactions. In cases where, following the acquisition, one party to the sale wishes to rent equipment or office space from the other party, there is a rental of space or equipment safe harbor. The employment safe harbor would apply in cases where the selling physician may continue as an employee of the acquiring entity. A physician may also continue in a professional capacity, but not necessarily as an employee, in which case the personal services safe harbor may be available.

2. Stark Law. The Stark Law prohibits certain financial relationships between physicians and providers of designated health services. If a physician or his or her immediate family member has a financial relationship with an entity, the physician may not refer a Medicare or Medicaid beneficiary to the entity for designated health services and the entity may not bill for services unless a Stark Law exception applies. Violation of the Stark Law is punishable by a \$15,000 civil penalty and exclusion from the Medicare and Medicaid programs.

In the case of a practice acquisition, payment of the purchase price creates a “financial relationship” between a physician seller and a buyer. Note that while physician services are not “designated health services” under Stark, it is important to consider whether designated health services are involved in the transaction, either from the seller or buyer’s perspective. Designated health services include:

- Clinical laboratory services
- Physical therapy
- Radiology services, including MRI, CT and ultrasound
- Radiation therapy services
- Durable medical equipment and supplies
- Parenteral and enteral nutrients, supplies and equipment
- Outpatient prescription drugs
- Prosthetics, orthotics and prosthetic devices and supplies
- Home health services
- Occupational therapy
- Inpatient and outpatient hospital services.

Regulations have been promulgated under the Stark Law containing detailed exceptions to its application. There is an exception for isolated transactions between a physician and another entity that may apply to the purchase and sale of a medical practice. There is also an exception for rental of office space and equipment, which could be available in cases where the buyer and seller wish to have a continued relationship for those items. The Stark Law also has an employment exception in cases where the seller physician continues to work for the practice that he or she sold. Personal services arrangements, such as a consulting arrangement between the selling physician and acquiring practice may also be structured to comply with a Stark Law exception.

It is important to keep in mind that the Stark Law requires strict compliance with each exception. Unlike the Antikickback Statute, which may permit arrangements that fall outside a safe harbor, any arrangement that does not meet each element of an exception constitutes a Stark Law violation, and the prohibition on referral of and billing for Medicare or Medicaid services would apply.

B. Tax Exempt Status. In the purchase and sale of a professional practice, either the seller or the buyer (or occasionally both) may be tax exempt under Section 501(c)(3) of the Internal Revenue Code. A tax-exempt organization must be organized and operated exclusively for an exempt purpose. A tax-exempt entity, such as a hospital, may acquire a practice provided that such acquisition is consistent with its charitable purpose (such as providing health care) and is on an arms-length, fair market value basis. Compliance

with tax exemption requirements is essential, both in determining the value to be paid to the physician for his or her practice, and the compensation, if any, to be paid to the physician if he or she is to be an employee or contractor of the tax exempt organization following the practice sale.

1. **Private Benefit.** In order to be considered exempt, a 501(c)(3) organization must serve a public rather than a private interest. However, the organization may confer a private benefit, as long as it is purely incidental to the public benefit it serves. For example, an exempt hospital may benefit a physician who is employed by the hospital through the payment of a purchase price to acquire the physician's practice, as long as the private benefit to the physician is incidental to the public benefit the hospital provides.

2. **Private Inurement.** Private inurement exists when any net earnings of a tax-exempt organization inure to the benefit of an "insider", such as a private shareholder or individual. "Private shareholder or individual" refers to persons having a personal and private interest in the activities of the organization. There is no de minimis exception to the private inurement proscription, which applies to all physicians, either individually or as part of a medical group that sells assets to a tax-exempt organization and all physicians who subsequently perform services for the exempt organization.

3. **Intermediate Sanctions.** In 1996, Congress added Section 4958 to the Internal Revenue Code, which permits the IRS to impose Intermediate Sanctions, a less extreme penalty than revoking the organization's tax-exempt status. The law imposes substantial excise taxes on "disqualified persons" who benefit from an "excess benefit transaction" with a charitable organization. An "excess benefit transaction" is one in which the organization provides a benefit to a disqualified person that has a value in excess of what the organization received for providing the benefit, such as a hospital overpaying for services provided by a physician. A "disqualified person" is one who exercises substantial influence over the affairs of an organization. Thus, if a hospital acquires the practice of a member of its medical staff it must ensure that it pays no more than fair market value in order to avoid Intermediate Sanctions and potential revocation of its tax exempt status.

There is a rebuttable presumption of reasonableness that the IRS must overcome before imposing intermediate sanctions. Generally if the transaction was approved by an authorized body of the organization, such as the board of directors, composed entirely of individuals who are unrelated to and not subject to the control of the insider, and if the authorized body obtained and relied on appropriate data as to comparability prior to making its determination and adequately documented the basis for its determination, the transaction is presumed to be reasonable. The process by which a hospital determines the purchase price and acquires the practice of a member of its medical staff is critical in complying with these regulations.

C. Antitrust Issues. Practice acquisitions that give the buyer monopoly or market power may violate federal or state antitrust or unfair competition laws. Section 2 of the Sherman Antitrust Act prohibits monopolies and the use of monopoly power, while Section 7 of the Clayton Act prohibits mergers that tend to lessen competition. However, an antitrust "safety zone" protects "physician network joint ventures", which are physician-controlled ventures in which the network's physician participants collectively agree on prices or price-related terms and jointly market their services, such as a hospital affiliated practice, IPA, PPO or group practice merger. Physician network joint ventures are comprised of physicians who share substantial financial risk and constitute 20% or less, on an exclusive basis, or 30% or less, on a non-exclusive basis, of the physicians in each physician specialty with active hospital staff privileges who practice in the relevant geographic market.

Networks that acquire physician practices and engage in joint pricing for the services of network physicians will be analyzed under a rule of reason to determine whether the formation and operation of the joint venture may have a substantial anticompetitive effect and, if so, whether that potential effect is outweighed by any procompetitive efficiencies resulting from the venture.

D. Medical Records. With respect to patient records, it is important to determine state law requirements regarding the period of time that records must be retained and made available to patients. Selling physicians must assure that the buyer agree to serve as seller's agent and accept responsibility for retention and patient access for the statutory period.

In the purchase and sale of a medical practice, the question arises of how to transfer certain patient information, or protected health information (PHI), from the seller to the buyer without violating the HIPAA Privacy Rule. A seller is permitted to share PHI with a buyer pursuant to a business associate agreement because the buyer, as a business associate, will use the PHI for “health care operations”, a permitted use under HIPAA. “Health care operations” include business management and general administrative operations of the entity, including the sale, transfer, merger or consolidation of all or part of the covered entity with another covered entity.

The American Medical Association provides further guidance for the transfer of patient records upon the sale of a medical practice. Ethical Opinion 7.04 states, “The transfer of records of patients is subject, however, to the following: (1) All active patients should be notified that the physician (or the estate) is transferring the practice to another physician who will retain custody of their records and that at their written request, within a reasonable time specified in the notice, the records or copies will be sent to any other physician of their choice... (2) A reasonable charge may be made for the cost of duplicating records.”

In the best of all worlds, both buyer and seller conclude a transaction happily. There may, however, be transition adjustments for the seller (if he or she is continuing to practice with the buyer), for staff of the Practice, and for the patients. Unless an issue was addressed in the Purchase Agreement as a continuing obligation or representation of either buyer or seller, it will likely need to be addressed as part of the new chapter of the Practice.