

Journal of Health Law

Winter 2004 Volume 37, No. 1

PRACTICE RESOURCE
Physician/Hospital Joint
Ventures in the
Wake of *St. David's*:
Reference Material

James A. Christopherson



PRACTICE RESOURCE

Physician/Hospital Joint Ventures in the Wake of *St. David's*: Reference Material

*James A. Christopherson**

I. JOINT VENTURE CHECKLIST (Based on 2002 CPE Text)

The following checklist can help determine if a joint venture between a tax-exempt organization and a for-profit entity satisfies the requirements of Rev. Rul. 98-15. It is not exhaustive, nor is it conclusive as to how an organization can achieve a favorable result in a joint venture arrangement. The checklist is useful, however, to ensure compliance with *situation 1* of Rev. Rul. 98-15.

Joint Venture
Reference

151

- Did the exempt organization receive an ownership interest in the joint venture proportionate to the value of the assets it contributed?
- Does the exempt organization have voting control over the joint-venture board with respect to policies and actions that affect the exempt organization's tax-exempt purposes?
- Are the representatives of the exempt organization on the joint-venture board representative of the community?
- Does the exempt organization have voting control on joint-venture policies and actions that affect the exempt organization's tax-exempt purposes?

* This material was adapted from "Physician/Hospital Joint Ventures in the Wake of *St. David's*," presented by the author at a joint session of Health Lawyers' *Hospitals and Health Systems* and *Physicians and Physician Organizations* seminars on February 12, 2004.

- Does the joint-venture agreement require the joint venture to operate its hospitals or other healthcare options for charitable purposes, by community-benefit standards?
- Does the joint-venture agreement explicitly state that the joint venture's duty to further charitable purposes overrides its duty to operate for the financial benefit of its partners or members?
- Does the joint-venture agreement include a dispute-resolution provision that would cause the joint venture to satisfy charitable purposes without regard to profitability when a disagreement arises between the board and the members over the joint venture's policies or actions?
- Are the provisions in the joint-venture agreement with respect to charitable activities legal, binding, and enforceable under the laws of the state where the joint venture was formed?
- Does the joint-venture agreement contain a noncompete provision that causes the exempt organization to yield significant market advantages and competitive benefits to the for-profit partner or member?
- Does a company related to the for-profit partner or member manage the day-to-day operations of the joint venture?
- Are the terms and conditions of the management agreement reasonable and comparable to similar arrangements in the marketplace?
- Does the management company have a binding and enforceable obligation to further the charitable purposes of the exempt organization?
- Does the exempt organization have the unilateral right to terminate the management agreement if the management company is not acting to further (or is acting contrary to) the exempt organization's charitable purposes?
- If a CEO manages the day-to-day affairs of the joint venture, does the exempt organization have the uni-

Joint Venture
Reference

152

lateral right to remove the CEO if he or she is not acting to further (or is acting contrary to) the exempt organization's charitable purposes?

II. Key Provisions in the St. David's Organizational Documents

1. The manager shall cause the facilities to conduct the business and operations of the partnership in such a manner as to satisfy the community-benefits standard generally required of hospitals under Section 501(c)(3) of the Code.
2. The facility shall accept Medicare and Medicaid patients.
3. The facility shall accept all patients in an emergency condition in their emergency rooms without regard to the ability of such emergency patients to pay.
4. The facility shall maintain open medical staffs.
5. The facility shall provide public health programs of educational benefit to the community.
6. The facility shall generally promote the health, wellness, and welfare of the community by providing quality healthcare at a reasonable cost.
7. The Management Services Agreement (MSA) between Galen and the partnership further provides that, if Galen takes any action with a "material probability of adversely affecting" St. David's tax-exempt status, that action will be considered an "[e]vent of [d]efault."
8. The MSA authorizes St. David's to unilaterally terminate the contract with Galen if it commits such a "default."
9. St. David's and HCA each appoint half of the Board of Governors.
10. No measure can pass the Board of Governors without the support of a majority of the representatives of *both* St. David's and HCA.

Joint Venture
Reference

153

11. The Partnership Agreement permitted St. David's to appoint the initial CEO, subject to the approval of the HCA members of the Board of Governors.
12. The Partnership Agreement further provides that either HCA or St. David's can unilaterally remove the CEO.
13. The Partnership Agreement states that, if St. David's receives legal advice (from an attorney that has been deemed acceptable by both HCA and St. David's) that its participation in the partnership will hinder its tax-exempt status, St. David's can request dissolution.

III. IRS Rebuttal to St. David's Arguments

There are reasons to doubt that the partnership documents provide St. David's with sufficient control because of the following.

1. St. David's authority within the Board of Governors is limited. St. David's does not control a majority of the board. Thus, at best, St. David's can prevent the partnership from taking action that might undermine its charitable goals; St. David's cannot necessarily ensure that the partnership will take new action that furthers its charitable purposes.
2. Galen, which manages the operations of the partnership on a day-to-day basis, is a for-profit subsidiary of HCA. As a result, it is not apparent that Galen would be inclined to serve charitable interests.
3. The Board of Governors is empowered to deal only with major decisions, not the day-to-day operation of the partnership hospitals. Thus, St. David's could not, via its position on the board, overrule a management decision that fell outside the range of the board's authority.
4. The Partnership Agreement appears to permit St. David's to request dissolution only when there is a change in the law, not simply when the partnership fails to perform a few charitable functions.
5. HCA may not take seriously any threat of dissolution made by St. David's. HCA must be aware that St. David's

has a strong incentive not to exercise its power to dissolve the corporation.

6. The partnership documents include a noncompete clause, which provides that, in the event of dissolution, neither partner can complete in the Austin (TX) area for two years.

IV. Guide Sheet for Hospitals, Clinics, and Similar Healthcare Providers (adapted from 2004 IRS CPE Text)

INSTRUCTIONS – This guide sheet is designed to assist in the processing of certain healthcare provider IRC 501(c)(3) exemption applications. Generally, a “Yes” response indicates a favorable factor, whereas a “No” response indicates a potential concern. See the accompanying healthcare provider reference guide for assistance in completing this guide sheet. Contact [the IRS Exempt Operations] Technical [Division] for additional help.

| | Yes | No |
|---|-----|----|
| 1. Does the healthcare provider’s organizing document meet the “organizational test?” | | |
| 2. Does the healthcare provider have a community board of directors? a. If the healthcare provider does not have a community board and is part of a multi-entity healthcare system, are there any other IRC 501 (c)(3) entities in the system with a community board that has structural control over the healthcare provider? | | |
| 3. Does the healthcare provider have a conflict-of-interest policy covering its directors, principal officers, highly paid employees, and members of committees with board delegated authority that is similar to the policy recommended by the [IRS]? | | |
| 4. If the organization is a hospital, does it maintain an open medical staff whereby medical-staff privileges are available to all | | |

Joint Venture
Reference

155

| | Yes | No |
|---|-----|----|
| qualified physicians in the area consistent with the size and nature of its facilities? | | |
| 5. Is the healthcare provider a professional corporation organized under a corporate-practice-of-medicine state law? If Yes, send the application to EO Technical. | | |
| 6. If the organization is a hospital, does it maintain a full-time emergency room? a. Is the emergency room open to all persons regardless of their ability to pay? b. Does the hospital have arrangements with police, fire, and ambulance services to deliver patients to its emergency room? | | |
| 7. Does the healthcare provider accept persons covered under Medicare or Medicaid? a. If the healthcare provider has not obtained a Medicaid contract, has it pursued good-faith negotiations to obtain a Medicaid contract? b. If the healthcare provider doesn't accept Medicare, contact EO Technical. | | |
| 8. Does the healthcare provider have a charity-care policy, and is it communicated to the public? a. Was a copy of the charity-care policy submitted with the application? b. Does the charity-care policy provide for free or reduced rate medical care consistent with the patient's financial resources? | | |
| 9. Does the healthcare provider conduct a formal program of medical training, medical research, or community educational programs? | | |
| 10. Does the healthcare provider lease office space to physicians with whom it has a financial relationship? a. Was a copy of the lease submitted? | | |

Joint Venture Reference

| | Yes | No |
|--|-----|----|
| <p>b. Has the healthcare provider explained how it established a lease at fair market value?</p> | | |
| <p>11. Does the healthcare provider lease any equipment, assets, or office space from physicians or other individuals, corporations, or partnerships (aside from structurally controlled organizations) with an ongoing financial relationship with the provider?</p> <p>a. Was a copy of the lease submitted?</p> <p>b. Has the healthcare provider explained how it established a lease at fair market value?</p> | | |
| <p>12. Has the healthcare provider purchased medical practices, ambulatory surgery centers, or other business assets from physicians or other persons (1) who have substantial influence over the healthcare provider; (2) who are employed by the healthcare provider; or (3) who contract back with the healthcare provider to operate the business?</p> <p>a. Was a copy of the asset purchase agreement (purchase and sale contract) submitted?</p> <p>b. Is there an appraisal supporting the purchase price?</p> <p>c. Does the appraisal utilize the cost, market, and/or income methods, or some combination thereof, to arrive at fair market value?</p> <p>d. Does the asset purchase agreement include any retained rights by the seller to (1) affect future affiliations with others; (2) to determine if additional physicians can be hired; or (3) to repurchase the assets within a certain time period (other than a right of first refusal)?</p> | | |
| <p>13. Does the hospital offer recruitment incentives to physicians?</p> | | |

Joint Venture
Reference

| | Yes | No |
|---|-----|----|
| a. Are recruitment incentives consistent with Rev. Rul. 97-21, 1997-1 C.B. 121? | | |
| <p>14. Has the healthcare provider explained the amounts and bases by which it compensates its officers, highly compensated employees, and physicians?</p> <p>a. Were representative employment contracts submitted?</p> <p>b. Are compensation arrangements approved by an independent board of directors or compensation committee subject to a conflict-of-interest policy?</p> <p>c. If a physician's compensation is based on revenues, is there an incentive for providing charity care and/or meeting quality-of-care or patient-satisfaction benchmarks?</p> <p>d. If a physician's compensation is based on revenues, is there a cap on total compensation based on reasonable compensation for physicians in similar specialties in similar geographic locales?</p> <p>e. If a physician's compensation is based on revenues, are the revenues limited to the work product of the physician and/or nurse practitioner(s) under the direct supervision of the physician?</p> | | |
| <p>15. Does the medical provider employ a for-profit medical group to serve its patients?</p> <p>a. Was the professional-services agreement or employment contract submitted with the application?</p> <p>b. Is total compensation reasonable based on the factors in Q14?</p> | | |
| <p>16. Does the healthcare provider participate in a joint venture, partnership, or limited liability company (LLC) arrangement with a for-profit entity?</p> <p>a. Were copies of all such agreement(s) provided?</p> | | |

Joint Venture Reference

158

| | Yes | No |
|---|-----|----|
| <p>b. Did the healthcare provider receive ownership interest in the joint venture, partnership, or LLC proportionate to its contribution?</p> <p>c. Are all returns of capital and distributions of earnings made to the members proportional to their ownership interests?</p> <p>d. Is a majority of the governing board chosen by the tax-exempt healthcare provider?</p> <p>e. Does a majority of the governing body approve major decisions that include: the annual capital and operating budgets; distribution of earnings; selection of key executives; acquisition or disposition of healthcare facilities; contracts in excess of a specific dollar-amount threshold; changes to the types of services offered by the hospital; and renewal or termination of any management agreements?</p> <p>f. Do the governing documents require it to operate all of its healthcare entities (including any healthcare entities contributed by the for-profit) in a manner furthering charitable purposes?</p> <p>g. Do the governing documents explicitly provide directors have a duty to operate in a manner furthering charitable purposes, and this may override their duty to operate for the financial benefit of the for-profit members?</p> <p>h. Are the governing documents legal, binding, and enforceable under applicable state law?</p> <p>i. Are any management contracts for a definite term of years and terminable for cause? Were copies of management contracts provided?</p> <p>j. Has the applicant provided information to establish that the terms, fees, and conditions of any management agreements are reasonable and comparable to management contracts of other</p> | | |

Joint Venture Reference

| | Yes | No |
|--|-----|----|
| <p>organizations providing similar services at similarly situated healthcare entities?</p> <p>k. Have you determined that no officers, directors, or other employees of the healthcare provider who were involved in the decision-making or the negotiations involving the formation of the joint venture, partnership, or LLC were promised employment or any other inducements by the for-profit and any of its related entities, or the joint venture, partnership, or the LLC itself?</p> <p>l. Have you determined that none of these individuals has any interest, directly or indirectly, in the for-profit or any of its related entities?</p> | | |
| 17. Is the healthcare provider an HMO? If Yes, send application to EO Technical. | | |
| 18. Is the healthcare provider a faculty group practice? If Yes, send application to EO Technical. | | |
| 19. If the organization is a fire, rescue, or emergency-service provider, does it offer comparable services to the entire community? | | |
| 20. Does the hospital or clinic qualify as a hospital described in IRC 509(a)(1) and 170(b)(1)(A)(iii)? | | |
| 21. Is the healthcare provider a drug treatment center, a community mental health center, or skilled nursing facility? | | |

Joint Venture Reference

160