Hospitals As Employers: 10 Things Investors Must Know

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Private equity investors have had steady interest in investing in physician practice management (PPM) models for various physician practice specialties for many years. It seems as if this interest has been rapidly increasing in recent years with numerous successful private equity-backed PPM businesses in a variety of specialties, including anesthesia, surgical subspecialties, dermatology and other specialties.

Many successful PPM businesses begin with a well-chosen foundation practice that serves patients in a specific geographic market, with expansion to other geographic markets through de novo growth of new clinics or acquisitions of existing clinics.

Because there is such a heavy local focus on both the proper selection of the original clinic location (the "hub" in a hub-and-spoke model) as well as the later added-on clinics, it is important for private equity investors to understand the role of local hospital systems as a possible alternative opportunity for the physicians who might otherwise be interested in joining a PPM business.

This article discusses 10 key issues that all private equity companies interested in a PPM model should understand.

1. The Trend Away From Private Practice Continues. According to a 2012 American Medical Association (AMA) study, since 2000, hospital employment of physicians has increased 32 percent with 17.3 percent of all physicians now directly employed by hospitals or health systems. Similarly, a Jackson Healthcare study presents the following data, confirming that more physicians are employed by hospitals in 2013 than 2012 and that the solo practitioner continues to disappear.

- Between 2012 and 2013, solo practitioners decreased from 21 to 15 percent. During the same period, hospital-employed physicians increased from 20 to 26 percent, while physicians working as nonownership employees increased from 12 to 15 percent.
- Thirty-nine percent of physicians younger than 45 years of age have never worked in private practice.

This changing landscape of physician desires and practice patterns does present some opportunities for private equity investors, in addition to hospitals, to step in as an aid to ease the financial and administrative strain on physicians.

2. Level of Autonomy is a Key Consideration. Doing front-end evaluation of the physicians' goals in any employment model is critical for ensuring long-term success. For most physicians, the level of autonomy to practice as the physician chooses to practice (from supplies and HER selection to referral decisions to administrative tasks) is a critical determinant in how attractive an opportunity is. Although not necessarily always the case in practice, a private equity-backed PPM business theoretically has greater flexibility on offering physician autonomy than a hospital system.

3. Ease of Startup and Unwinding is Another Key Consideration. One of the important factors for physicians when considering an opportunity is the ease and costs of starting the relationship and the barriers involved in unraveling the relationship.

Physicians will need to understand that any employment arrangement with a PPM-managed practice or hospital requires a large outlay of capital by the acquirer and typically a heavy set of associated penalties and restrictions on terminating the relationship in the short term.

It is typically also costly for physicians to return to full private practice upon termination of an employment arrangement if the assets of the practice have been purchased by the acquirer, the nonphysician employees have transitioned employment and other significant steps have been taken. Thus serious consideration of the risks and rewards will be inevitable elements of the consideration for the physicians.

4. Evaluating Physician Productivity and Financial Opportunities is Critical. In addition to ensuring that the financial arrangement and services make sense on day one for both the employer and physicians, it is critical that the participants take care to ensure that the transactions are properly structured to encourage long-term commitment by the physician to the business. This is true for both PPM and hospital opportunities.

Some employers and physicians have been dismayed to learn 12-18 months into the relationship that what appeared to be a fruitful structure with base salary and performance goals on day one did not provide for long-term viability for either the hospital or physicians.

Careful consideration of short-term changes in reimbursement, the outside activities of the physicians, the physicians' referral relationships and other elements of the relationship are critical front-end analysis steps to better understand what impact the transaction will have on the physicians' practice.

5. Reimbursement Can Be a Factor as Well. One way in which the value to the employer may be impacted is on reimbursement for the applicable physician services that the employing entity (i.e., the hospital or the PPM-managed practice) expects to receive post-closing.

Some hospital systems are powerful enough that they have strong payor relationships that can garner enhanced reimbursement both for physician services and associated ancillary revenues (surgical facility, laboratory, imaging and other "technical component" service lines).

Unless a particular PPM is unusually large such that it can begin to achieve payor contracting relationships, this reimbursement differential to the employing entity can impact how the employing entity uses the value of the acquisition opportunity and the resulting compensation.

6. Hospitals Can Offer Some Additional Benefits. Private equity investors will also confront the reality in many geographies that local hospital systems can offer additional benefits that a private equity-backed PPM model cannot.

For example, in some areas, the hospital is a major employer with its own health plan, and physicians who become employed by that hospital will then immediately have access to that patient base. Likewise, some more powerful health systems are major employers of physician referral sources (primary care physicians, for example) and limit the ability of their employed physicians to refer to specialists if the specialists are not also employed. These may be additional benefits that any physician considering joining a PPM model will have to weigh against the other opportunities of the PPM model.

7. Private Equity-Backed PPM Models Offer Other Benefits. By contrast, a PPM model can offer some flexibility and opportunities that hospital employment cannot. Some hospital systems are extremely limited in their ability to permit employed physicians to invest in ancillary businesses, such as surgery center, dialysis facilities, real estate investments, etc., whereas a PPM model may permit more flexibility in this regard.

Additionally, some private equity investors favor a PPM model where one or more physicians are involved in the management entity as owners and/or active participants in that management business, which is a unique feature of a PPM model that appeals to many physicians.

8. Antitrust Considerations Will Be Important for Hospitals. Any hospital-physician employment requires an antitrust analysis as the integration will involve essentially a merger of previous competitors. For example, as a result of a recent ruling, released Jan. 24, St. Luke’s Health System was ordered to divest its acquisition of Idaho’s largest independent medical group, Saltzer Medical Group.

St. Luke’s had acquired the medical group in an area where they wanted to develop a new hospital that St. Luke’s argued would provide improved care coordinating and development of an accountable care organization. The judge found that since the combined organization comprised 80 percent of the primary care physicians in the area, thereby creating a dominant local market position, the transaction violated federal antitrust laws.

This case provides an important lesson for future hospital-physician transactions, reminding participants to analyze their impact on market share prior to committing to any acquisition, and it is less likely to be a factor that a private equity-backed PPM business would face unless the PPM-managed practice is unusually large and dominant in a particular geographic area.

9. Tax-Exempt Status Considerations Will Also Be Important for Hospitals. In many instances, the hospital is a nonprofit entity seeking to maintain 501(c)(3) tax exempt status, and many of those are governed by the religious directives of their founders/owners. Such hospitals will necessarily consider the impact of the physician integration strategy on their tax exempt status, including ensuring the fair market value status of the compensation, ensuring the arrangement does not involve elements of prohibited private inurement, ensuring that the physicians' practice patterns are in line with the hospitals' missions (e.g., charitable purposes, limitation on services by religious-based systems, etc.).

Physicians will need to fully understand and weigh how these aspects of the hospital's governance and operation will impact their practice going forward, including the impact on any productivity-based element of the compensation structure — an issue that a private equity-backed PPM business likely will not face.

10. Stark Law Compliance Remains Important in All Such Relationships. In any employment strategy, if there are certain ancillary services involved, such as laboratory, durable medical equipment or imaging, the relationship should be structured to meet an applicable Stark Law exception.

The available Stark Law exceptions have numerous elements that must be met to ensure the appropriateness of the arrangement, but a common theme among all of these is that the compensation payable to the physician must be fair market value for the services performed.

Analyzing the applicable exception will be a critical component of any negotiation. Likewise, federal and state anti-kickback, self-referral, and fraud and abuse laws should be examined to ensure the appropriateness of the relationship under these other laws.

These 10 key considerations described above are certainly not "one size fits all" comments about the opportunities for physicians with a hospital as compared to a PPM-managed practice. The factual circumstance of a particular physician practice acquisition opportunity will vary greatly depending on the size of the practice, the power of local health systems, the patient base, the existence of ancillary opportunities and other factors.

However, if private equity investors keep the foregoing considerations in mind as they evaluate an opportunity, we believe they will be well-poised to structure an attractive offer for the physician and enhance the likelihood of long-term success for the business.

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