A medical practice is not a typical business. Medical practices are heavily regulated under both state and federal law, are dependent upon the personal services of their owners, and most often receive their revenue from someone other than their customers (i.e., health plans). The attorney handling the sale or purchase of a medical practice, therefore, must address not only the issues that apply to business acquisitions generally, but also the special concerns that apply to these unique enterprises.

Physicians occupy a special role and recognition in our society, not only because of the education, training and skill required, but also because of the emphasis our society places on quality health care. This special role sometimes obscures the fact that a medical practice is a business enterprise that must generate profits in order to continue. Like other businesses, medical practices have life cycles that include start-up, growth, maturity and wind-down phases. Owners of medical practices often find themselves facing a sale decision because of an actual or threatened decrease in, or loss of, insurance reimbursements or other revenue, disagreements among owners, inadequate profitability or the opportunity for strategic growth (such as expansion to new regions or new referral opportunities) offered by the buyer. While the frenzied pace of medical practice acquisitions of the mid- and late-1990s—fueled by physician practice management companies and hospitals—has subsided, there are still sensible, practice-specific reasons why medical practices are bought and sold.

Types of Transactions

As a preliminary matter, the attorney representing a medical practice in a merger or acquisition transaction needs to be familiar with the advantages and disadvantages of the main types of transactions.

Asset Purchase—The purchase of the selling practice’s assets is generally the preferred type of transaction for purchasers, and the least preferable for sellers. In an asset purchase, the purchaser acquires specified assets from the seller, such as equipment, furniture, medical records and goodwill. If the purchaser elects, the purchaser also assumes specified liabilities such as employee salary and benefit obligations and commitments under provider agreements with health plans. A purchaser often prefers an asset purchase because the purchaser believes this type of transaction is less likely to result in the purchaser becoming liable for unassumed liabilities.1 In addition, the purchaser is usually able to “book-up” the value of the purchased assets for tax purposes, meaning the purchaser will enjoy increased depreciation deductions after the purchase that can decrease the taxes paid on the business’s income going forward.

An asset purchase has two disadvantages from the seller’s perspective. First, if contracts are being included in the assets transferred, the consent of other parties to these contracts may be required. Many types of contracts—including office leases, medical equipment leases, loans and health-plan participating-provider agreements—may be required.
agreements—prohibit transfer of the contract without the written consent of the other party. A federal court ruling interpreting Virginia law held that non-compete agreements are not assignable without the employee’s consent, unless express language to that effect is included in the agreement.\textsuperscript{2}

There are sizable civil penalties for violating the Stark law, including denial of Medicare or Medicaid reimbursements as well as significant monetary fines.\textsuperscript{3}

Likewise, the sale of a surgery center or other regulated medical facility in connection with the sale of a medical practice may require regulatory review by the Virginia Department of Health.\textsuperscript{4}

Second, asset purchases can be very tax inefficient for the seller. The worst result is if the seller is a C corporation,\textsuperscript{4} because the sale of assets by a C corporation very often will result in double taxation to the corporation’s shareholders.\textsuperscript{5} This problem can be so significant that finance companies exist that actually attempt to reduce this double tax burden.\textsuperscript{6} Under certain fact patterns, the effects of double taxation may be reduced in a medical sale by allocating a portion of the purchase price to the personal goodwill or non-competition agreements of the owners.\textsuperscript{7} Even if the selling entity is a limited liability company (LLC), S corporation or other pass-through entity not subjecting its owners to double taxation, an asset purchase can result in a significant portion of the purchase price (including the value of any accounts receivable purchased) being taxed at ordinary income tax rates, rather than capital gains rates.\textsuperscript{8}

These tax problems can be avoided if the purchaser and seller are both corporations and the transaction qualifies as a tax-free acquisition under IRC § 368(a)(1)(C).\textsuperscript{9} Likewise, a seller that is an LLC or partnership may be able to defer taxation if the purchase price is being paid in stock or other ownership interests of the purchaser, or certain other consideration other than cash and marketable securities.\textsuperscript{10}

**Stock Purchase**—The seller often prefers the stock purchase because it avoids the need for the seller to obtain consent from parties to key contracts or agencies issuing needed permits. However, care needs to be exercised with major contracts, loans and leases, which often state that a “change in control” of one party will require the consent of the other party. Depending on the wording of the particular contract, a stock purchase may result in such a prohibited change in control.

The stock purchase is generally taxable to the selling owners at favorable capital gains rates.\textsuperscript{11} If the stock purchase involves two corporations and qualifies under IRC § 368(a)(1)(B), taxation of these gains can be deferred.\textsuperscript{12} If LLC membership interests or partnership interests are being acquired for stock or other ownership interests of the purchaser; taxable gain may be deferred under certain circumstances.\textsuperscript{13}

From the purchaser’s perspective, a stock purchase can be less favorable. In a stock purchase, the purchaser receives no “book-up” in tax basis, unless the seller is a corporation and the parties agree to treat the transaction as an asset purchase for tax purposes under IRC § 338.\textsuperscript{14} Also, a stock purchase involves the assumption of all liabilities of the seller’s business that are known, unknown or contingent. The purchaser who agrees to a stock purchase often seeks to minimize this risk by obtaining substantial representations and warranties from the seller and escrowing a portion of the purchase price to cover any breaches.\textsuperscript{15}

**Merger**—In a merger, the assets of the selling practice are transferred by operation of law to the purchaser. A merger requires filing of articles of merger with the governmental office that oversees business organizations (in Virginia, the State Corporation Commission).\textsuperscript{16} There is broad flexibility in merging different types of entities.\textsuperscript{17} The basic merger\textsuperscript{18} is like an asset purchase in the sense that third-party contractual and governmental consents may be required. However, the merger is in some ways like a stock purchase, in that the purchaser acquires all liabilities, both known and unknown, of the selling business.\textsuperscript{19} It is somewhat easier to qualify a merger of two corporations as tax-deferred under IRC § 368 than it is an asset or stock purchase.\textsuperscript{20}

**Employment Arrangements**

In many purchases of medical practices, the tangible assets are sold for their book value,\textsuperscript{21} and no portion of the purchase price is allocated to the practice’s goodwill. A significant portion of the payments for the transaction instead come in the form of salaries, bonuses, independent contractor fees, non-compete payments and other forms of compensation to the physician-owners of the selling business. The main reason for payments being structured in this way is that the revenues in a physician practice are generated primarily from the personal services of its owners and other professional employees. Without the services of these individuals, the typical medical practice has very little value. Keeping this fact in perspective, it makes sense for the purchaser to insure that these valuable employees are properly compensated.

As discussed briefly below, however, care must be taken in structuring compensation arrangements with the selling business’s owners, in order to avoid violating federal and state anti-referral laws.\textsuperscript{22} In particular, a selling physician cannot be paid for the volume or value of his or her referrals to the purchaser; instead, payments should be based on the value of professional services provided by the selling physician following the sale. For this reason, particular caution needs to be exercised in compensating referring physicians.

**Health Law Issues**

Medical practices and their payment arrangements are heavily regulated under both federal and state law. These laws and regulations can significantly impact the way in which a purchase and sale of a medical practice is structured.

**Federal**

**General**—The two main laws governing economic arrangements involving medical practices are the Medicare/Medicaid “anti-kickback statute” (often referred to as “fraud and abuse law”), 42 U.S.C. § 1320a-7a et seq. and the Ethics in Patient Referral
Act of 1989, as amended (often called the “Stark law”), 42 U.S.C. § 1395nn. The hazard to an attorney involved in the sale or purchase of a medical practice is that these laws are extremely vague, the “safe harbor” regulations established for these statutes are drawn very narrowly (and in some cases are not final) and federal regulators have been very aggressive in prosecuting physicians—and in some cases, their advisors—when regulators believe these statutes have been violated.

Fraud and Abuse—The fraud and abuse law is a criminal statute requiring the knowing and willful offer of payment of any remuneration to induce someone to refer a patient for any item or service reimbursable under Medicare or Medicaid. In addition to criminal penalties, a person that violates the fraud and abuse law may be barred from participating in Medicare and Medicaid and subject to civil penalties. The Office of the Inspector General of the U.S. Department of Health and Human Services has taken the position that even if a physician has multiple purposes in making and entering into a particular economic arrangement, if merely one of those purposes is to cause a referral in violation of the fraud and abuse law, then that law has been violated.

Stark—In contrast to the fraud and abuse law, the Stark law is a civil statute. Under the Stark law, physicians are strictly liable if the law is violated, regardless of their intent. The Stark law prohibits a physician or his or her immediate family members from having a financial relationship with an entity to which the physician makes referrals for designated health services covered by the Stark law. There are sizable civil penalties for violating the Stark law, including denial of Medicare or Medicaid reimbursements as well as significant monetary fines.

Safe Harbors—The federal agencies administering these laws have issued regulations establishing “safe harbors.” These regulatory safe harbors, if followed, will assure the purchaser and seller of a medical practice that these agencies will not consider a violation of the fraud and abuse law and Stark law to have occurred. The safe harbor regulations are complex and are covered in more detail in another article in this magazine. In certain instances they are conflicting, in others they are overlapping and by and large they have not yet been time tested. In structuring a sale or purchase of a medical practice, it is best to attempt to comply fully with one or more of the applicable safe harbors for both statutes (for example, those relating to the sale of a medical practice or employment/independent contractor compensation arrangements). However, if the economics of the transaction do not permit full compliance with the relevant safe harbors regulations, the parties should seek to comply. Failure to comply with the safe harbor regulations does not indicate a violation of the fraud and abuse law or the Stark law. The combined practice should be integrated under one Medicare billing number, and the number of independent contractor physicians limited, to comply with the Stark law.

HIPAA—The Health Insurance Portability and Accountability Act, or HIPAA, was adopted in 1996. HIPAA applies to all medical practices. HIPAA requires medical practices to have privacy policies regarding personal health information of patients, and to provide patients with written notice of these policies. Purchasers of medical practices should focus on the provisions of HIPAA relating to privacy of personal health information of patients, and whether the selling practice is complying with these provisions and the associated regulations.

State

Self-Referrals—Virginia has a state counterpart to the fraud and abuse law, known as the Virginia Practitioner Self-Referral Act. This law prohibits a licensed healthcare practitioner from referring a patient for health services to an entity outside the practitioner’s office or group practice, if the practitioner has an investment interest in the entity. Violations can result in disciplinary action or monetary penalty. Although few opinions on the application of this law have been issued by the Virginia Department of Health Professionals, many attorneys believe substantial compliance with the fraud and abuse safe harbor regulations in the sale of a medical practice will avoid issues under this Virginia law.

Medical Records—Virginia is one of only a handful of states that does not prescribe how long a physician must maintain medical records. Medical records should be maintained for as long as medical or administrative needs for them exist. Medical records obviously are kept to document patient care, but they are also maintained for a number of reasons that have little to do with direct patient care. Chief among these is to assist in the defense of the practice if a patient brings a medical negligence claim involving treatment. The purchaser has an increased incentive to maintain medical records, since the purchaser generally has no firsthand knowledge of potential claims arising prior to the purchase.

Virginia law prohibits any licensed healthcare practitioner from transferring a patient’s records in connection with the sale of a professional practice, until an attempt has first been made to notify the patient of the transfer both by mail and newspaper advertisement. The notice must inform the patient of the right to request that his or her records be sent to another provider, or copies be furnished to the patient.

Corporate Practice of Medicine—Virginia generally follows the rule prohibiting the “corporate practice” of medicine, meaning that non-licensed individuals or businesses cannot own professional medical practices. While there has been some erosion of this doctrine, there is still a consensus that non-professionals cannot have legal ownership of a medical practice in Virginia.

Other Issues

Securities Laws—Except in an asset purchase entirely for cash, securities laws issues are likely to be present in a business acquisition. Any stock purchase or merger involves the issuance of the securities by the seller to the purchaser. Similarly, if the sellers are acquiring equity or debt instruments of the purchaser, the purchaser will be offering securities to the sellers. Under federal and state securities laws, almost all medical practice sales will qualify for an exemption from being registered with the U.S. Securities and Exchange Commission or applicable state securities regulators. However, liability under the antifraud provisions of federal and state securities laws cannot be avoided because a securities offering is exempt from registration. The best defense to securities fraud exposure in the sale of a medical practice is for each
... physician practice mergers can also result in antitrust law violations, particularly where the resulting practice has dominant market share in a particular medical specialty.

Endnotes:
1 However, note that purchasers can become liable for unassumed liabilities in certain instances, even when using an asset purchase. See City of Richmond v. Madison Mgmt. Group, Inc., 918 F.2d 438, 450-51 (4th Cir. 1992).
4 A tax-paying corporation under Subchapter C of the Internal Revenue Code.
5 See Internal Revenue Code (IRC) § 1001, 331.
6 The finance company attempts to reduce the taxes incurred by the selling corporation’s shareholders by purchasing their stock immediately after the asset sale, for a price less than the purchase price paid to the corporation for the assets, but greater than the distribution to the shareholders after taxes. The finance company apparently is able to offset the selling corporation’s gain from the sale of assets using accelerated losses from credit card receivable write-offs and similar accelerated deductions held by the finance company.
8 See IRC § 1221, 751.
9 Tax-deferred treatment generally requires that at least 70% or more of the selling corporation’s gross assets and 90% of its net assets be acquired solely for voting stock of the purchasing corporation. IRC § 368(a)(1)(C). There are numerous other requirements that must be met for tax-deferred treatment.
10 IRC § 731. If the purchaser is a corporation and the purchaser’s corporate stock is being issued, the transaction must qualify under IRC § 351 in order to be tax deferred. Qualification under IRC § 351 is usually difficult in this situation, because the recipients of the stock would need to own 80% of the purchaser’s voting power and stock immediately after the closing.
11 Ordinary income tax rates will apply if one selling business is a LLC or partnership to the extent the purchase price is attributable to accounts receivable or appreciated inventory (referred to as “hot assets”). IRC § 751.
12 Tax deferral generally requires that at least 80% of the stock of the selling corporation be acquired solely for voting stock of the purchasing corporation. IRC § 368(a)(1)(B).
13 See supra, Note 10.
14 A so-called “§ 338 election” can have significant tax costs to the purchaser.
15 Some insurance companies offer “representation and warranties” insurance policies to pay damages if the seller’s representations or warranties are breached. This policy is often paid for by the seller in order to avoid a large escrow of the purchase price proceeds.
18 Also known as the “forward merger,” in which

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Conclusion

The sale or purchase of a medical practice—like any other business—requires the attorney to have a thorough understanding of the economics of the transaction, the motivations of the parties and the relevant law. The body of health-care law that applies to these transactions comes from many sources and can seem confusing or at times nonsensical, to the attorney that typically focuses on matters outside the health-care field. Proper planning and research can go a long way to prevent surprises when your medical practice client is involved in a purchase or sale transaction.

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more “investors who are in a position to make or influence referrals to, furnish items or services to, or otherwise generate business for the entity” may hold no more than forty percent of the ownership interests.25 Many joint ventures involve a number of physicians, physician groups and other providers (including hospitals), which collectively own more than forty percent of the entity. Thus, the small business safe harbor does not apply.

Joint ventures that do not satisfy a regulatory safe harbor must be analyzed on a fact and circumstances basis, which analysis typically focuses on whether the parties are engaged in “willful and knowing conduct.” Features that require particular scrutiny include the manner in which investors are selected and retained, the nature of the business structure, and the manner in which the joint venture is financed and distributes profits.26 Joint ventures which may be at risk include those: (a) which offer larger ownership interests to physicians who refer more patients to the joint venture, (b) in which a party that already provides certain services or goods enters into an arrangement with the joint venture in which the joint venture is made or influence referrals to, furnish items or services to, or otherwise generate business for the entity, (c) in which the business structure, and the nature of the business, and the manner in which the joint venture is financed and distributes profits.

The Anti-Kickback Statute is a criminal statute and violations are punishable as felonies.

Mergers continued from page 37

the acquired business is merged into the purchasing one. A reverse merger occurs when the purchasing business is merged into the acquired business; this form of transaction is often used if the selling business has contracts or permits prohibiting assignment without the consent of the contracting party or relevant agency. A “triangular” occurs when the purchasing business forms a subsidiary that is merged with the selling business; this type of transaction is often used to provide the purchaser with a layer of limited liability protection.  

Endnotes:

1 Practitioners should note also the existence of state law analogs to both the Self-Referral Statute and the Anti-Kickback Statute (including statutes at Va. Code Ann. § 54.1-2410 et seq. and Va. Code Ann. § 18.2-502). Analysis of state law is beyond the scope of this article but will be an important part of any legal analysis of these issues.

2 42 C.F.R. §411.353(b) (69 Fed. Reg. 16054, 16133 (March 26, 2004)). Final Stark regulations were published on March 26, 2004 and will become effective July 26, 2004, subject to comments accepted during a comment period ending June 24, 2004. Unless otherwise noted, all references to the Code of Federal Regulations are to regulations published at 69 Fed. Reg. 16054 – 16146.


4 See generally 42 C.F.R. §411.354 (2004). “Compensation arrangement” is a catch-all category that includes virtually any relationship in which compensation changes hands and includes employment agreements, leases, and independent contractor relationships.

5 Id. at (c)(2).


7 Id. at (g)(3). Although it is beyond the scope of this article, it should also be noted that Stark violations may be actionable under the federal False Claims Act, 31 U.S.C. §§3729-3733.


9 42 C.F.R. §411.357(a) (2004). Note that an indirect financial relationship between the physicians and the hospital may also exist, notwithstanding the availability of an exception for the lease. See 42 C.F.R. Section 411.354(a)(3) (2004).


12 42 C.F.R. §411.357(c) and (d) (2004).

13 42 C.F.R. §411.355(a) and (b) (2004).

14 See 42 U.S.C. §1320a-7(b).

15 The Anti-Kickback Statute applies solely to referrals for services or goods which may be paid for, in whole or in part, by a federal health care program. For the sake of brevity, in this section II we will use the term “Medicare/Medicaid” to refer to all federal health care programs.

16 See 42 U.S.C. §1320a-7(b)(3) and 42 C.F.R. §1001.952.

17 This is a critical element of the statute and it is significant to note that Federal courts are still wrestling with what constitutes “willful and knowing” conduct. See Bryan v. United States, 118 S.Ct. 1939 (1998); United States v. Davis, 132 F.3d 1052 (9th Cir. 1997); Hansteret Network v. Shahala, 51 F.3d 1390 (9th Cir. 1995). It is also important to be aware that some courts have interpreted the statute to mean that an arrangement is illegal if any one purpose is to induce referrals, notwithstanding any other bona fide purposes. (See United States v. Greber, 760 F.2d 68 (3rd Cir.), cert. denied 474 U.S. 988 (1985)).

18 See 42 C.F.R. §1001.952(b).

19 See 42 C.F.R. §1001.952(b)(5).

20 See 42 C.F.R. §1001.952(b)(3).

21 See 42 C.F.R. §1001.952(d).

22 See 42 C.F.R. §1001.952(d)(3).


27 OIG for the fraud and abuse law and the U. S. Centers for Medicare and Medicaid Services (CMS) for the Stark law.

28 For example, the fraud and abuse safe harbor for sale of a medical practice allows installment payments to be made to the seller over a number of years, while the Stark law safe harbor allows installment payments only if the obligation is guaranteed or secured. Compare 42 C.F.R. §1001.952(e) with 69 Fed. Reg. 16,098 (March 26, 2004).

29 The purchaser of a medical practice is not prohibited from purchasing the Medicare accounts receivable of the selling practice by the Medicare rules against physician reassigning their right to bill Medicare. See letter of Kathleen Butto, Sale of Medical Practice, Bureau of Eligibility, Reimbursement and Coverage (CMS) dated September 22, 1998.

30 PL 104-191, 104th Congress (August 21, 1996); 110 Stat. 1936 et seq.


32 Va. Code § 54.1-2410 et seq.


34 Va. Code § 54.1-2405. Sending such a notice would also appear to provide a defense against patient abandonment.

35 Id.


38 For example, Sections 4(1) and 4(2) of the Securities Act of 1933, as amended, will exempt most medical practice sales from registration with the U. S. Securities and Exchange Commission.