Select Issues in Academic Medical Center Joint Ventures

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January 2013

In response to the changing reimbursement and healthcare regulatory environment as well as new entrants in the healthcare service provider industry (i.e. payors), Academic Medical Centers (“AMC’s”) are increasingly open to considering joint ventures with investor owned and tax exempt entities. When putting together such possible combinations, AMC’s would be well advised to consider the following material issues which are frequently the source of significant a discussions:

Shared Goals and Culture.

Whether the parties share the same goals for the joint venture is a crucial factor in creating a successful joint venture. For example, if the AMC’s primary goal is to defend its present market position throughout a region and the other party desires to enter new markets, the likelihood of the joint venture achieving each of those goals is remote at best.

Assuming that the goals are aligned (which may be a big assumption), how each of the parties seek to achieve those goals separately in their own organizations will greatly influence their ability to achieve those goals through the joint venture. Accepting the fact that your potential partner may approach the resolution of an issue differently than your organization will allow your organization to keep its focus on the goal rather than the process by which your partner makes decisions. Are decisions made by 3 different committees or one individual?

Similarly, understanding who the key decision makers are within not only your partner’s organization but also the AMC’s organization and engaging those persons as early and as often as possible in the process is very important. Admittedly a trite example, but we were involved in a process where a time period had been referenced as “one year” for about 6 months during the negotiations of the joint venture documents. Once a new stakeholder at the AMC became involved, the phrase was changed to “twelve months”. When a different stakeholder was introduced to the negotiation a little later in the process, “twelve months” became “365 days”. On the surface, such changes were certainly immaterial to the drafting of the documents. However, they caused us to question the ability of our partner to speak with one voice and to worry whether previously negotiated compromises were subject to being undone by other stakeholders that had not been identified or involved in the process.

Finally, whether the parties are committed to the venture is key. It sounds simple but in practice it can be very difficult to achieve. If one party is accustomed to getting what it wants most if not all of the time, the fact that is not going to happen in the joint venture context can be very difficult to accept. Approaching the venture as partners, rather than as adversaries in a zero sum negotiation, is crucial.

Economics.

The economic aspects of the joint venture need to be carefully delineated and understood by all involved. The basic questions to be answered include

1) who is putting in how much capital?
2) who decides when additional capital will be contributed?
3) how will the profits shared?
(4) who determines whether excess cash will be distributed?

When these questions are not adequately addressed when the joint venture is being created, a potentially great relationship can quickly turn litigious. We were involved in a three party relationship that was designed to secure the future of the AMC. Several months after the agreements were signed, things began to unravel when money that the AMC thought was going to be spent by one of its partners for certain purposes was spent on other matters. As a result, the AMC decided to spend some money that it had indicated would be spent on a project on other matters as well. Things went downhill from there. The parties could have avoided heading down this slippery slope (and the resulting litigation) if they had been willing to openly discuss their respective perspectives on the economic issues.

**Governance.**

How the joint venture makes decisions is always an important element in creating a successful enterprise. The most common structure we see includes a governing body with members appointed by each party. While the governing body makes decisions concerning matters that are more often strategic in nature (acquisition of a business, approval of strategic plans, budgets, etc…), the day to day operation of the business is delegated to one of the parties pursuant to a management agreement.

Whether the relative governance rights of the parties should mirror the financial rights and obligations of the parties (i.e. capital contributions) is a material issue. If more of the AMC’s capital is at risk than its partner’s capital, why should the partner have an equal say about decisions that ultimately impact the return on the AMC’s capital? Conversely, if the parties are “partners”, shouldn’t they agree on important things?

In some instances, there may be outside factors that influence whether the AMC and its partner will have equal governance rights. *St. David’s Health Care System v. United States* and Revenue Ruling 98-15 (both of which address the contribution of a tax exempt hospital to a joint venture with an investor owned company) place a great deal of emphasis on the ability of the tax exempt entity to “control” the joint venture or at least certain aspects of its operations. Absent the contribution of the hospital by the AMC to the joint venture, these authorities are likely not applicable.

Even if the AMC and its partner do not equally share governance, there may be certain items that are so material to fostering the partnership mentality, that the approval of both parties is required. Among other matters, these super majority actions may include whether to sell the business, to buy a business, to enter contracts with affiliates of either party, to terminate a service line, to alter the charity care policy, to borrow money in excess of specified amount, to approve a budget or to adopt a strategic plan.

Whether in a shared governance or super majority model, the AMC and its partner often address how they will resolve disagreements on such matters. Arbitrating such disputes is frequently suggested. However, arbitration generally is not a workable solution since there is no “right” answer to whether the joint venture should, for example, enter a new service line. Mediation is a much better approach. Although the joint venture may engage a trained professional to assist in the mediation process, incurring such expenses are not necessary and may even run counter to the partnership approach. See *Exhibit A* for a suggested informal mediation provision.

In the event that the parties are unable to resolve their disagreement, two alternatives are frequently explored. If the disagreement concerns a very material issue that goes to the core of why the parties formed the joint venture, the disagreement may trigger the right of one party to buy out the equity interests of the other. Alternatively, the status quo may be maintained and the action that triggered the
disagreement is not taken by the joint venture. See Exhibit B for a suggested approach to resolving disagreements concerning budgets.

**Buy-Sell Rights.**

How and when the joint venture gets wound up is always an issue. In addition to rights of first refusal with respect to a party’s proposed sale of its equity interest to a third party, it is not unusual for the definitive agreements to grant one party the ability to “call” the equity interests of the other party under certain circumstances. Similarly, the agreements may grant one party the right to “put” its interest to the other. Common triggers of these types of rights include the passage of time, breach of the agreement, change in control of a party or deadlock.

As noted above, it is not unusual for a deadlock to give rise to buy sell rights. Perhaps one of the most equitable approaches is often referred to as “Russian roulette” or a “shotgun” provision. This approach allows a party to offer to buy the other party’s units at a specified price. If the other party does not wish to sell at that price, it has the right to buy out the other at that same price. See Exhibit C for a suggested provision.

In some circumstances, the mission of the AMC and its market position may be such that it will never want to be the “seller”. The scope of the rest of its enterprise that is not part of the joint venture may be so vast that it would not want to help create a competitor in the marketplace should the AMC have its interests acquired by its partner.

In determining the price at which buy out rights are exercised, the parties often agree to use a third party appraisal of the “fair market value” of the interests. Whether such amount is subject to a minority discount or determined net of the enterprise’s debt are frequently points of contention. Similarly, whether a floor or ceiling is imposed can also be subject to negotiation. For example, the AMC may wish to “lock in” the lowest price at which a sale would occur equal to the valuation of the enterprise when the joint venture was formed. Conversely, it may wish to establish a ceiling (such as 7 x EBITDA) so that it can set aside the capital necessary in order to exercise its right to buy out its partner.

Note that, if one of the reasons why the AMC entered the joint venture was to have better access to capital, consider whether its buy out rights are illusory if it cannot or is not willing to deploy its capital to buy out its partner.

**Scope of Exclusivity.**

Many joint venture agreements contain non-compete provisions so that the party’s interests remain aligned towards the success of the joint venture. It is common that such provisions apply both during the period a party owns an equity interest and for some period of time thereafter. The rationale for the “tail” period is simply fairness - it would be unfair for a party to use the proceeds received from selling its interests to compete with the joint venture.

The scope of the restricted activities are crucial and should align with the reasons why the joint venture was created. If one of the goals of the joint venture is to acquire and operate certain hospitals or ancillary businesses in a specified geographic area, the partners generally should not be able to do those same things in that specified area. These provisions are often heavily negotiated by AMCs who are concerned with any limits on their ability to fulfill their academic and healing missions. Special attention is also paid to how existing business operations of the AMC or its partner that are not contributed to the joint venture are operated within the geographic area. See Exhibit D for a suggested provision that addresses these issues.
Affiliation/Service Line Agreements

Many Academic Medical Centers possess a great deal of expertise in one or more service lines that may be able to assist the joint ventures operations. Whether the joint venture should be obligated to use those service lines on an exclusive basis and the price paid by the joint venture for such services are often the subject of negotiation. If the joint venture is required to use those service lines, may it cease doing so if it can obtain better or equal quality assistance from a third party? Since the AMC owns a portion of the joint venture, the parties also frequently consider whether the form of agreement that the AMC would use with a third party should be modified for use with the joint venture.

Physicians

Academic Medical Centers are rightly concerned with the identity and qualifications of their faculty. The research and teaching elements of practicing in a AMC setting are simply different than practicing in a traditional community hospital setting. However, the AMC looks towards the revenues produced by its faculty practice plan to help defray the costs of employing the faculty physicians.

All this leads to negotiations concerning whether the physicians hired by the joint venture should in fact be employed by the AMC’s faculty practice plan. Much like the service line issues described above, whether the faculty practice plan of the AMC will be the exclusive provider of certain types of additional physician services is, and if so, at what cost, are key issues to address.

Anti-Trust

The potential anti-trust implications of joint ventures with academic medical centers are often overlooked but should be taken into consideration while creating the joint venture. Anti-trust issues arise in the joint venture context in the event that the AMC (or the other partner) “competes” with the joint venture, whether for patients, employees or otherwise. If it does, the parties may need to address how competitively sensitive information (such as strategic plans, wages and payor contracts) is handled. The facts and circumstances of each arrangement (such as whether one party “controls” the joint venture) are crucial in permitting special anti-trust counsel craft structural means to address and potentially eliminate the anti-trust issues.
Exhibit A

Informal Dispute Resolution

Section #. Board of Governors Deadlock or Dispute. It is the intention of the Board of Governors to make a good faith effort to settle any Material Dispute. In settling any Material Dispute, each of the Category A Governors and the Category B Governors (each, a category of Governors) shall act in accordance with the following procedures:

(a) First, each category of Governors shall negotiate in good faith with the other category of Governors to try to settle any Material Dispute for a period of forty-five (45) days. If applicable to the nature of the Material Dispute, the Governors shall give priority to the fulfillment by the Company of the Company Purposes. The Board of Governors shall meet a minimum of three times during such period (in person to the extent practicable) to attempt to resolve the Material Dispute.

(b) In the event that by the end of the 45-day period referred to in Section #(a), the Material Dispute is not settled pursuant to the procedures set forth in Section #(a), the Chairman of the Board of the X Member and the Chief Executive Officer of Y Member shall meet (in person to the extent practicable) to attempt to resolve the Material Dispute. If the Material Dispute is still not resolved after such meeting(s), then the Company shall continue to operate its business with respect to the subject of the Material Dispute in the same manner as it previously operated its business.
Exhibit B

Budget

Notwithstanding the foregoing, in the event the Board of Governors should be deadlocked with respect to the approval of an annual capital budget or an annual operating budget, the Manager shall have the right, power and authority to make expenditures on behalf of the Company for budgeted items in amounts up to the following: (a) with respect to each item of operating expense other than taxes and insurance, an amount equal to the amount set forth in the most recent annual operating budget that has received the Approval of the Board, increased by the percentage increase, if any, in the Consumer Price Index for the period beginning on the date upon which such most recent annual operating budget received the Approval of the Board and ending on the first day of the fiscal year in which such expenditure is to be made; (b) with respect to each item relating to taxes and insurance, an amount equal to the amount of the actual expense incurred by the Company in respect of such item; and (c) with respect to each item of capital improvement or capital expenditure, an amount equal to the amount deemed necessary by the Manager to preserve the safety or condition of the Hospital, its patients and other occupants, to avoid the suspension of any services provided by the Hospital, to replace existing capital equipment, to preserve the accreditation of the Hospital and its services, or to respond to a recommendation of the medical staff of the Hospital. Notwithstanding the foregoing, if any emergency involving manifest danger to life or property exists with respect to which expenditures are necessary for the preservation or safety of the Hospital, for the safety of the patients and other occupants of the Hospital, or to avoid the suspension of any necessary service to the Hospital, such expenditures may be made by the Manager without the prior Approval of the Board.
Exhibit C

Russian Roulette aka Shotgun

Section #. Triggering Event.

(a) Within sixty (60) days after the occurrence of a Triggering Event, any Member (the “Initiating Member”) may give written notice (an “Offering Notice”) to the other Member (the “Other Member”) of the intent of the Initiating Member to buy all, but not less than all, of the Units owned by the Other Member or to sell all, but not less than all, of the Units owned by the Initiating Member in accordance with the provisions of this Section #.

(b) The Offering Notice shall specify the aggregate cash purchase price at which the Initiating Member values all of the interests in the Company (the “Total Value”). The Offering Notice also shall specify that the Member who ultimately purchases all of the Units pursuant to the provisions of this Section # shall be obligated to either: (i) obtain the release of any selling Member from any liability for any indebtedness of the Company, any contractual obligations of the Company or any guaranty of any of the foregoing; or (ii) to indemnify the selling Member against the foregoing.

(c) Upon receipt of the Offering Notice, the Other Member shall be obligated either: (i) to sell to the Initiating Member for cash all of its respective Units at a price equal to the Total Value multiplied by a fraction, the numerator of which is the number of Units owned by the Other Member and the denominator of which is the total number of Units issued and outstanding, or (ii) to purchase from the Initiating Member for cash all of the Initiating Member’s Units at a price equal to the Total Value multiplied by a fraction, the numerator of which is the number of Units owned by the Initiating Member and the denominator of which is the total number of Units issued and outstanding.

(d) The Other Member shall notify the Initiating Member of the Other Member’s election to sell or purchase within thirty (30) days after the date of the receipt of the Offering Notice. Failure to give such notice within the required time period shall be deemed an election by the Other Member to sell its Units to the Initiating Member.

(e) The closing of any sale or purchase pursuant to this Section # shall take place within thirty (30) days after the expiration of the thirty (30) day notice period specified in Section #(d) above. At the closing of any such sale, the purchase price shall be paid in cash, and the Units shall be sold, free and clear of all liens, claims and encumbrances. The parties agree to execute such documents as may be necessary to effectuate the sale.
Exhibit D

Non-Compete and Opportunities

Section #. Covenant Not to Compete.

(a) In consideration of the premises and as a material inducement for the X Member and the Y Member to enter into this Agreement and consummate the transactions contemplated hereby and by the Contribution Agreement, each Member and their respective Affiliates agrees that while such Member is a member of the Company and for a period of three (3) years thereafter, it will not (other than through the Company), directly or indirectly, in any capacity, own, manage, operate, control or maintain or continue any interest whatsoever with any Competing Business.

(b) In addition, each Member and their respective Affiliates agrees that while such Member is a member of the Company and for a period of three (3) years thereafter, it will not (other than through the Company), directly or indirectly, in any capacity, own, manage, operate or control or maintain or continue any interest whatsoever in any other health care business (which is not a Competing Business) within a 25-mile radius of the Hospital, unless each of the following conditions is satisfied: (a) the Company does not provide the same or substantially the same services proposed to be offered by the Member or its Affiliate; (b) the Member or its Affiliate gives the Company sixty (60) days prior written notice describing the proposed activity or service (including its location); (c) the Board of Governor, after considering the proposed activity or service does not vote within the sixty (60) day notice period to pursue the opportunity (and the Member which pursues the opportunity or its representatives on the Board of Governors voted in favor of the Company pursuing the opportunity). If the Board of Governors decides to pursue the opportunity, it shall implement the activity or service within six (6) months of the date of the notice. If the Company fails to implement the activity or service within the six (6) month period, the Member or its Affiliates (as applicable) may thereafter implement the activity or service. However the Company’s exclusive six (6) month period to begin to implement the activity or service can be extended by the Company so long as it is diligently proceeding to obtain the approvals necessary to implement the activity or service.

(c) Notwithstanding Section #(a), Y and its Affiliates (i) may own stock in any publicly held corporation listed on a national securities exchange or whose stock is regularly traded in the over the counter market as long as such holding at no time exceeds five percent (5%) of the total outstanding stock of such corporation; and (ii) may continue to own and operate the businesses described on Schedule #(c).