



CAN NONPROFIT HOSPITALS COEXIST WITH PHYSICIAN OWNERSHIP?

Hospitals, both nonprofit and for-profit, are increasingly sharing control over profitable healthcare delivery assets with physicians. Nonprofit hospitals in particular are struggling with how best to retain their physician referral base when the hospitals' tax-exempt status and the federal and state anti-kickback and self-referral (Stark) laws make sharing ownership and revenue with physicians more difficult to accomplish. The primary challenge facing many nonprofit hospitals today is winning the loyalty of leading physicians who want to own their own specialty hospital, ambulatory surgery center or medical device company.

HOW DID WE GET HERE?

Physicians began looking to generate additional sources of revenue in the early 1980s as managed care companies started to reduce the income of physicians. To counter the loss in income, physicians began to offer more billable ancillary services in their offices. As the payors reduced payments for inpatient services, both hospitals and physicians began to develop more outpatient services. To avoid direct competition with their medical staffs, some hospitals focused on developing joint ventures with leading physicians. These joint ventures have proliferated in every aspect of outpatient care.

Although the Stark law made these joint ventures more difficult to create, exceptions to the Stark law were enacted, particularly the "in-office ancillary services" exception, permitting physician ownership of facilities offering "designated health services" to which they referred patients. Physicians developed their own in-office designated health services that directly competed with hospitals for lab and imaging services. As a result, hospitals struggle to maintain their market share for many outpatient diagnostic services.

PHYSICIAN HOSPITAL OWNERSHIP: THE NEW TREND

Traditionally, hospitals have been successful in working with physicians through joint ventures and "under arrangement" deals for a variety of outpatient services. But more and more physicians are taking ownership to the next level. Relying on the Stark law "whole hospital" exception, physicians are permitted to own an interest in the entire hospital to which they refer patients. This exception has allowed for-profit hospitals to offer key physicians an ownership interest in the hospital and to build physician loyalty.

However, unlike for-profit hospitals, physicians cannot become co-owners of tax-exempt hospitals. Typically, a nonprofit hospital will offer its leading physicians more opportunities for "under arrangement" transactions or joint ventures in which the hospital accepts a diluted interest in a hospital service and the physicians agree to a strong non-competition or liquidated damages provision. However, it remains to be

seen whether this strategy can generate additional volume or minimize the referral of patients to physician-owned facilities.

THE SPECIALTY HOSPITAL: ANOTHER TREND

The "whole hospital" exception to the Stark law also paved the way for the creation of specialty hospitals that focus on the more profitable hospital services, such as cardiac and orthopedic surgical services. These hospitals enjoy a cost advantage over acute care facilities, since they usually do not have emergency rooms and traditionally do not accept charity care patients, although that may soon change. Specialty hospitals offer physicians another way to compete with local community hospitals for the most profitable patients and services.

PHYSICIAN-OWNED MEDICAL DEVICE COMPANIES: THE NEWEST TREND

The growth of physician-owned medical device companies may reduce the profitability of some medical devices, particularly orthopedic and cardiac implants. These physician-owned medical device companies develop devices and sell them to hospitals and physicians, who then use them on their hospitalized patients. While it is unclear how these new ventures will impact a hospital's bottom line, it is clear that physicians are finding new ways to control the revenue stream.

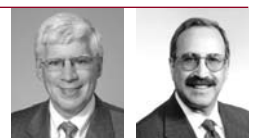
WHAT CAN TAX-EXEMPT HOSPITALS DO?

As these trends progress, tax-exempt hospitals will have increasing difficulty maintaining physician loyalty, particularly in markets with physician-owned hospitals. Therefore, nonprofit hospitals should strongly consider including physicians in new ventures that the hospitals undertake. In particular, tax-exempt hospitals can find opportunities to build loyalty with physicians left out of "whole hospital" deals. As another strategy, tax-exempt hospitals might develop a competing for-profit specialty hospital with physician ownership as a rival to their for-profit competitors. Furthermore, some tax-exempt hospitals might convert to taxable status because the benefits of tax exemption are outweighed by the ability to retain physician loyalty through physician ownership in the hospitals. Finally, tax-exempt hospitals need to build physician loyalty by finding new ways to partner with those physicians seeking to develop new medical devices. Offering the medical staff a collaborative medical device development program may prove invaluable in the long run. Regardless of how tax-exempt hospitals react to these new physician income trends, one thing is certain – these trends are surging and tax-exempt hospitals need to adapt in order to survive.

If you have a question on this material, or would like to discuss legal services, please contact us at healthcare@duanemorris.com.

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