

*Health Care Industry Valuation Insights*

## HEALTH CARE JOINT VENTURES: LEGAL AND VALUATION ISSUES

*Lisa Rediger Hayward, Esq., Charles A. Wilhoite, CPA/ABV, ASA,  
and LaVerne Woods, Esq.*

*This article describes the numerous legal and valuation issues related to the joint venture of a not-for-profit entity and a for-profit entity. In addition, an illustrative example of a not-for-profit/for-profit joint venture valuation analysis is presented.*

### INTRODUCTION

Joint ventures between not-for-profit health care organizations and for-profit entities have become a common feature of the health care industry landscape. These joint venture transactions include:

1. the “whole hospital” joint ventures, in which a tax-exempt hospital contributes all of its assets and operations to a joint venture entity in partnership with a for-profit entity that contributes cash and/or assets, and
2. the far more common “ancillary” joint ventures, such as ventures to (a) create ambulatory surgery centers, (b) acquire magnetic resonance imaging (MRI) units, and (c) operate other facilities and equipment.

Ancillary joint ventures typically comprise only a small part of the not-for-profit entity’s activities.

Every joint venture between a not-for-profit entity and a for-profit entity raises significant legal and (often) valuation issues. Indeed, many of the key legal issues are valuation-related.

If the respective contributions of the parties to the venture are not appropriately valued, then the joint venture arrangement may run afoul of a host of federal and state laws. These laws include: (1) requirements for federal and state tax exemption, (2) federal and state anti-kickback laws, (3) the federal physician self-referral statute, and (4) state law fiduciary obligations for nonprofit boards.

### FEDERAL TAX EXEMPTION

A not-for-profit health care organization that has a federal tax exemption under Section 501(c)(3) (such as a hospital or not-for-profit clinic) or Section 501(c)(4) (such as a

network-model health plan) must be credited fully with the value of its contributions to a joint venture with a for-profit party. Likewise, a not-for-profit entity that effectively overpays a for-profit partner for the partner’s assets or services in a joint venture can jeopardize its tax exemption.

A not-for-profit health care organization that enjoys federal tax exemption may permissibly engage in a joint venture with for-profit parties, including physicians on its medical staff, without putting its exemption at risk. This is true so long as the joint venture structure meets certain parameters.

Specifically, the joint venture must be structured in a manner that:

1. includes adequate protections to ensure that the venture is operated for an appropriate tax-exempt purpose and
2. does not provide an impermissible level of benefit to the for-profit parties.

The first prong of this legal analysis may require that the documents of the joint venture:

1. include statements of the joint venture’s charitable purposes,
2. provide for the joint venture’s provision of identified community benefits,
3. include dispute resolution provisions that take into account the charitable nature of the venture’s purposes, and
4. allocate special governance rights to the nonprofit.

The not-for-profit party will generally seek at least a 50 percent role in governance, with certain reserved powers to determine policy issues. The policy issues may include the level of charity or subsidized care that the joint venture

will provide. This is a feasible structure even though the nonprofit may contribute less than 50 percent of the value of the joint venture's assets.

From a legal perspective, the not-for-profit entity's role in governance may be greater than the proportionate value of its assets contributed and its share of income and loss in the venture. From a practical perspective, however, for-profit parties are reluctant to concede governance powers to the not-for-profit entity that are significantly disproportionate to its economic contribution.

This second prong of the legal analysis goes directly to valuation issues. It is essential that all aspects of the joint venture are engaged in (1) at arm's-length and (2) for fair market value. These conditions are necessary in order to avoid providing an impermissible benefit to the for-profit parties.

Joint ventures between not-for-profit entities and for-profit entities are most commonly structured (1) as limited partnerships or (2) as limited liability companies. These structures can: (1) limit liability of the parties, (2) preserve the tax-exempt nature of joint venture income to the nonprofit party where the venture's activities further exempt purposes, and (3) avoid the double taxation to the for-profit investors that would generally arise with a corporate form joint venture.

At the outset, at the time that the joint venture entity is created, the value of each party's contributions to the joint venture must be ascertained. This is necessary to determine each party's share of income and losses in the enterprise. Those shares must be proportionate to their contributions. This is, of course, a simple matter when all parties are contributing only cash, but that is rarely the case.

In the situation of facilities, such as ambulatory surgery centers, the not-for-profit entity often contributes the assets of a going business, potentially including goodwill. The Service has clearly indicated that the not-for-profit organization must be credited with the value of any existing business contributed in order for the joint venture to pass muster under federal tax law. This credit includes the value of the income generated by the facility.

Once formed, the joint venture entity will commonly enter into a management contract (1) with the not-for-profit or one of the other partners or (2) with an entity owned by one of them. Here, again, it is essential (1) that the terms of any agreement represent fair market value for the services to be provided, and (2) that the venture does not pay below market value for the services rendered by a nonprofit manager, or above market value for the services rendered by a for-profit manager.

Similarly, any payments for professional or other services performed by the venture parties or others must be at arm's-length for fair market value. Other arrangements, such as leases, must similarly comply with market norms.

The level of risk to the not-for-profit of jeopardizing its tax-exempt status from engaging in a joint venture with for-profit parties depends on the pre-existing relationship between the nonprofit and those other parties.

Where one or more of the joint venture parties is an "insider" with substantial influence over the nonprofit (such as a director or officer, a key medical staff member, or a medical group responsible for substantial hospital admissions), an improper valuation can result in prohibited "private inurement" of the nonprofit's assets to those other partners. This private inurement could disqualify the not-for-profit entity for tax exemption.

In this situation, there is a corresponding risk to the "insiders" who engage in the transaction. They may become subject to "intermediate sanctions" penalty taxes based on the amount of any "excess benefit" they are deemed to receive as a result of the venture.

The Service may initially (1) impose a penalty tax on the insider equal to 25 percent of the excess benefit, and (2) require the insider to return any such benefit to the nonprofit. If an insider fails to return any such benefit, an additional tax of 200 percent of the excess benefit may apply.

Penalty taxes of up to \$10,000 per transaction may also apply to any officer or director of the not-for-profit entity who knowingly approves an excess benefit transaction. The intermediate sanctions penalties do not apply to the not-for-profit organization itself.

## REBUTTABLE PRESUMPTION

It is possible to create a "rebuttable presumption" that a transaction with an insider is reasonable and for fair market value. This is true if the nonprofit organization follows specific procedures described in the Treasury regulations.

By satisfying the rebuttable presumption procedures, it is possible to create some measure of protection against penalties for both:

1. insiders who are parties to the joint venture and
2. the not-for-profit entity officers and directors who approve the transaction.

To create the rebuttable presumption, the organization must take the following steps:

1. The transaction must be approved in advance by independent members of the nonprofit's board, or a committee of the board, with no participation by directors who have a conflict of interest such as a personal financial interest in the transaction or a family relationship with any party to the transaction.

2. The board or committee must rely on “appropriate comparability data,” such as an appraisal, a compensation and benefits analysis, or other valuation study.
3. The board or committee’s determination must be documented in writing concurrently, such as in minutes.

The documentation should describe the terms of the transaction, the individuals who were present during debate and those who voted on it, any actions taken concerning anyone who had a conflict of interest, and the comparability data that the board or committee is relying on and how it was obtained.

The tax law does not require not-for-profit organizations (1) to follow these procedures or (2) to obtain a valuation study. However, a well-advised not-for-profit organization will seek to follow the rebuttable presumption procedures. By following these procedures, the not-for-profit entity board can also help to ensure that it is satisfying state law fiduciary obligations.

Even when the joint venture partners are not insiders with respect to the not-for-profit entity, an inappropriate valuation that benefits partners who are individuals or for-profit entities can result in an impermissible level of “private benefit.” This “private benefit” is compared to the public benefit (e.g., by expanding the health care facilities available in the community) that the joint venture may provide. Excessive private benefit is another basis for revocation of tax exemption.

In states that follow federal standards for tax exemption, these issues will similarly affect continued qualification for state tax exemption.

## ANTI-KICKBACK AND STARK LAWS

Valuation issues are also central to compliance with federal anti-kickback legislation and the federal physician self-referral statute (commonly known as the “Stark Law”). These issues may be relevant to compliance with applicable state law as well.

The federal anti-kickback statute makes it a crime to pay, offer, or receive any remuneration in exchange for referrals of Medicare or Medicaid patients. If a not-for-profit entity enters into a joint venture with physicians, an inappropriate valuation benefiting the physicians (e.g. an undervaluation if the physicians are buying in or an overvaluation if physicians are being bought out) could be viewed as a payment for the physicians’ referrals to the not-for-profit. And, an inappropriate valuation could expose the

parties to the joint venture to risk under the federal anti-kickback statute.

The Stark Law prohibits a physician from referring Medicare patients to an entity for certain “designated health services” if the physician has a financial relationship with the entity, unless an exception applies. The financial relationship may be direct or indirect. A financial relationship includes (1) an ownership or investment interest or (2) a compensation arrangement. Consequently, a joint venture between a not-for-profit health care organization and physicians typically involves an analysis of the transaction under the Stark Law.

There are a number of safe harbors to the anti-kickback statute. If an arrangement fully satisfies the requirements of an applicable safe harbor, the parties are protected from liability under the statute. Similarly, there are a number of statutory and regulatory exceptions to the Stark Law, and an arrangement must fit within an applicable exception. Otherwise, the Stark Law prohibits referrals from the physician to the not-for-profit entity.

*“ . . . proper valuation of a health care joint venture is essential to compliance with the federal anti-kickback statute and Stark Law.”*

Although the anti-kickback safe harbors and the Stark exceptions have unique elements, they commonly require that a transaction or arrangement involve compensation that is consistent with fair market value. The Stark Law, in particular, contains a general definition of fair market value.

Under Stark, the term “fair market value” means the value in an arm’s-length transaction consistent with the price that an asset would bring as the result of *bona fide* bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party.

There are also specific definitions of fair market value in the context of equipment leases and space leases. The federal agencies charged with interpreting and enforcing the anti-kickback statute and Stark law have issued a variety of guidance over the years that are pertinent to valuation in a health care transaction. Consequently, proper valuation of a health care joint venture is essential to compliance with the federal anti-kickback statute and Stark Law.

## NOT-FOR-PROFIT ENTITY AND FOR-PROFIT ENTITY JOINT VENTURE—AN ILLUSTRATIVE CASE STUDY

The following illustrative case example addresses several of the legal and valuation issues that can arise with regard to the operation of a joint venture between (1) a not-for-profit

health care organization and (2) a for-profit health care organization.

Rather than focus on the initial formation of the joint venture—including the required assessment of the relative contributions made by the parties to the joint venture and the associated ownership and governance rights—the example focuses on legal and valuation issues that can arise subsequent to the proper formation of such a venture.

## CASE FACTS

Joint Venture Hospital (JVH) represents a legally established limited liability company between (1) a tax-exempt, northeast-based university system (US) and (2) a national, for-profit hospital chain (FP). US contributed its primary teaching hospital (TH) to JVH. FP contributed cash and cancelled certain indebtedness owed by US to FP that was initially assumed by JVH.

In exchange for the relative value of their respective contributions, and based on discussion and negotiation, (1) US was allocated a 25 percent membership interest in JVH and (2) FP was allocated the remaining 75 percent membership interest.

However, the operating agreement of JVH (the “Agreement”) clearly established that JVH would be operated pursuant to the original educational and charitable mission of the US teaching hospital. The Agreement also granted US a 5-year option period for the purpose of selling any portion, or all, of its membership interest to FP. The Agreement calls for a price equal to the initial value attributed to the membership units of JVH at its formation date, adjusted for the change in working capital between (1) the formation date and (2) the date the option was exercised.

Additionally, the Agreement established FP as the day-to-day manager of JVH. The Agreement allows for compensation to FP for the management services rendered at a rate equal to a fixed percentage of monthly net revenue recognized by JVH.

After 10 years of operating JVH, US and FP determined that existing market conditions required consideration of the expansion and ultimate reallocation of some of the medical service capabilities of JVH. Based on the review and analysis of several strategic plans, US and FP concluded that a feasible alternative included the contribution (and ultimate conversion) of the assets of a neighboring acute care hospital (“ACH”) owned by FP to JVH.

However, and based on consideration of other pressing organizational investment needs and a current cash flow forecast, US concluded that it was not economically feasible to increase its original investment in JVH at the time of FP’s planned contribution of the ACH assets.

## LEGAL/VALUATION ISSUES

On the surface, the decision to accept the ACH assets contributed by FP appears to represent a simple and clear example of the need for an independent determination of the fair market value of the assets of ACH by a qualified appraiser. Such an appraisal would enable US and FP to attribute an appropriate, *and substantiated*, level of value to the capital account of FP.

Clearly, obtaining such an independent appraisal is in the best interests of US. This is primarily for the purpose of establishing that no excess private benefit would be transferred to FP as the result of crediting FP’s capital account for an amount in excess of the fair market value of the ACH assets contributed.

Given that JVH is a closely held (as opposed to publicly traded) entity, an equally significant (if not greater) issue is the need for an independent valuation of the contributed assets of ACH.

Because US elected not to increase its original investment in JVH, the decision to accept the ACH assets contributed by FP translated into a decision by US to accept ownership dilution with regard to its membership interest in JVH.

This issue is complicated by the fact that, due to the closely held status of JVH, no evidence exists that could reasonably be relied on to establish the current fair market value of JVH’s membership equity. As a result, the need for an independent valuation of the ACH assets creates a simultaneous need for an independent valuation of the membership equity of JVH.

Without a current indication of the fair market value of JVH’s membership, US would be exposed to the risk of accepting a greater-than-appropriate reduction with regard to its membership interest in JVH by agreeing to accept the contributed assets of ACH by FP. This would occur if an “assumed” (rather than independently determined) value for the membership equity of JVH were lower than the actual fair market value of the membership equity of JVH.

Similarly, the failure to obtain an independent fair market value appraisal with regard to the contributed assets of ACH exposes US to the risk of accepting a greater-than-appropriate reduction with regard to its membership interest in JVH. This would occur if an “assumed” value for the assets of ACH were higher than the actual fair market value of the assets on the date that the contribution is made.

The failure to obtain appraisals from qualified experts in transactional settings such as this could have significant financial and legal ramifications with regard to the operations of a tax-exempt health care organization, as discussed above.

As indicated in Exhibit 1, and based on the key variables identified, a 10 percent *understatement* of the membership

**Exhibit 1**  
**The Risk Associated with the Joint Venture's Failure to Obtain Independent Asset Appraisals**

JVH Original Membership Interest	
US	25%
FP	75%
Total	<u>100%</u>

in \$000s	
20,000	
60,000	
10%	
10%	

Valuation Variables as of the Asset Contribution Date:

Estimated Fair Market Value of the ACH Assets

Estimated Fair Market Value of JVH – “Pre-Contribution”

“Assumed” Fair Market Value of JVH below the Actual FMV

“Assumed” Value of ACH Assets Above the Actual Fair Market Value

**SCENARIO 1—Based on a Fair Market Value Analysis**

**“Pre-Contribution” Membership Allocation:**

Members/Venture Partners	Ownership Interest Allocation	Ownership Interest Value in \$000s
US	25%	15,000
FP	75%	<u>45,000</u>
Total	100%	60,000

**“Post-Contribution” Membership Allocation:**

Members/Venture Partner	Ownership Interest Allocation	Ownership Interest Value in \$000s
US	18.8%	15,000
FP	81.3%	<u>65,000</u>
Total	100.0%	80,000

**Resulting US Percentage Ownership Interest Dilution -6.3%**

**SCENARIO 2—Based on “Assumed” Asset Values**

**“Pre-Contribution” Membership Allocation:**

Members/Venture Partner	Ownership Interest Allocation	Ownership Interest Value in \$000s
US	25%	13,500
FP	75%	<u>40,500</u>
Total	100%	54,000

**“Post-Contribution” Membership Allocation:**

Members/Venture Partner	Ownership Interest Allocation	Ownership Interest Value in \$000s
US	17.8%	13,500
FP	82.2%	<u>62,500</u>
Total	100.0%	76,000

**Resulting US Percentage Ownership Interest Dilution -7.2%**

equity value of JVH (compounded by a 10 percent *overstatement* of the value of the assets of ACH), could result in US inappropriately agreeing to accept a reduction in its membership interest approximately one full percentage point higher than necessary as a result of FP's contribution of the ACH assets.

## TRANSACTIONAL GUIDANCE

A detailed review of valuation theory and the valuation process is beyond the scope of this discussion. However, it is important from the perspective of not-for-profit health care organizations that engage in transactional activity (whether frequently or infrequently) to be aware of steps to protect against the inadvertent violation of the laws discussed above.

Both federal and state laws require that transactions reflect fair market value prices based on an arm's-length standard.

Not-for-profit health care organization managers should consider several guidelines to facilitate the completion of joint venture arrangements and other transactional activities at prices/terms that comply with these standards. Recommended guidelines include the following:

1. Seek advice and assistance from qualified legal counsel for the purpose of developing a request for proposal from valuation analysts when considering a transactional opportunity.
2. Require that the valuation analyst possess, in addition to educational requirements, relevant valuation credentials—e.g., chartered financial analyst (CFA), accredited senior appraiser (ASA), certified public accountant/accredited in business valuation (CPA/ABV), certified business appraiser (CBA), and certified valuation analyst (CVA).
3. Require that the valuation analyst be experienced with regard to the valuation of the subject health care assets (in the case of tangible asset appraisals) and/or health care entities (in the case of going concern, business appraisals), or demonstrate a history of providing a significant level of valuation services in the health care industry.
4. Require that the valuation analyst be familiar with the legal issues previously identified, and can demonstrate an understanding of their implications with regard to the valuation process.
5. Require that the relevant valuation analysis be performed and documented, when necessary, in conformity with the *Uniform Standards of Professional Appraisal Practice*, which, among other requirements, mandate consideration of three approaches to asset valuation:

the income approach, the market approach, and the cost approach.

Clearly, following these procedures will not guarantee that a transaction entered into by a not-for-profit health care organization will not be challenged during a regulatory review process. Structuring a transaction that is based on upfront advice and continuing guidance from qualified legal counsel, however, and that relies on an appraisal completed by qualified valuation analysts, is one of the most economically practical and legally defensible strategies that a not-for-profit health care organization can employ.

## SUMMARY AND CONCLUSION

The risks to not-for-profit health care organizations of engaging in a joint venture with a for-profit party that violates the anti-kickback statute, federal Stark legislation, relevant provisions of the Internal Revenue Code, and related state statutes are significant. These risks include:

1. exposure to potentially significant criminal or civil fines and penalties—which often can be assessed to individuals,
2. exclusion from participating in the Medicare and Medicaid programs, and
3. in the most extreme case, revocation of a nonprofit health care organization's tax-exempt status.

The most practical approach for a not-for-profit health care organization to mitigate these risks is to rely on the advice and guidance of qualified legal counsel and valuation/financial analysts. The not-for-profit health care entity should consult with these professionals before engaging in transactional activity.

This is not a legal opinion or legal advice, which will always vary according to applicable facts.

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*LaVerne Woods is a partner with the law firm of Davis Wright Tremaine, LLP, in the firm's Seattle office. LaVerne chairs the firm's Tax-Exempt Organizations (TEO) group and is Chair of the American Bar Association Section of the Taxation Exempt Organizations Committee. LaVerne can be reached at (206) 622-3150, or at [lavernewoods@dwt.com](mailto:lavernewoods@dwt.com).*

*Lisa Hayward is of-counsel to the Seattle office of Davis Wright Tremaine, LLP. Lisa has extensive experience representing health care providers in mergers and acquisitions and joint ventures. Lisa can be reached at (206) 622-3150, or at [lisahayward@dwt.com](mailto:lisahayward@dwt.com).*

*Charles Wilhoite is the national director of health care financial advisory services at Willamette Management Associates, based in the firm's Portland, Oregon, practice office. Charles can be reached at (503) 243-7500, or at [cawilhoite@willamette.com](mailto:cawilhoite@willamette.com).*