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EXECUTIVE SUMMARY

**BUSINESS LAW AND GOVERNANCE
PRACTICE GROUP**

**The Affiliation of Swedish Medical Center and Minor & James Medical:
A New Approach to Physician-Hospital Affiliations**

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In September 2009, Minor & James Medical Professional Limited Liability Company (MJM), a large multi-specialty physician group with its main clinic in Seattle, WA, consummated an affiliation transaction with Swedish Medical Center (Swedish), a large, Seattle-based nonprofit healthcare system with three hospitals and more than 100 employed physicians, that was unique in the Seattle market and that may serve as a model for other affiliations between hospitals and physician groups nationally. A departure from the common physician-hospital affiliation models, the Swedish-MJM transaction permitted Swedish to make a significant capital investment in MJM while allowing MJM's physician members to retain a meaningful equity interest in the practice and control over its clinical affairs.

The Parties

Swedish is the largest nonprofit health provider in the greater Seattle market. Its services include three hospital locations in Seattle, a visiting nurse service,, and the Swedish Physician Division—a network of about forty primary-care and specialty clinics throughout Seattle and East King County.

MJM began practicing in 1959 with a core group of nine founding physician members. Since then, it has grown into a large, multi-specialty physician group, organized as a professional limited liability company, with more than seventy physicians in nine clinics located in Seattle, Mercer Island, Bellevue, and

Issaquah. In addition to offering a full range of primary care and specialty physician services, MJM also provides ambulatory surgery, imaging, sleep medicine, and clinical laboratory services.

Background

MJM had been searching for a capital partner to help it better respond to the changing healthcare environment, retain current physicians and recruit additional physicians to meet the community's healthcare needs, and to help it achieve operational efficiencies to enable it to provide patient services at lower cost. Because of its proximity and its fifty-year history of close collaboration with MJM, Swedish was a logical affiliation candidate and ultimately was selected by MJM as the capital partner that best fit MJM's needs. From Swedish's perspective, the affiliation with MJM offered Swedish the ability to align more closely with a sizeable medical group to provide enhanced medical services in the community, reduce the cost of care, and to prepare for changes in payment models that may result from healthcare reform.

The Structure

Hospital-physician group affiliations typically involve one of the following models:

- Employment Model—A hospital or an affiliate directly employs physicians;
- Foundation Model—A nonprofit affiliate of the hospital owns and operates the medical practices, employs all of the non-physician personnel, and contracts for physician services with a physician-owned entity;
- Management Services Organization (MSO) Model—An entity owned by the hospital or jointly by the hospital and physicians provides management services to a medical group;
- Physician-Hospital Organization (PHO) Model—A joint venture between a hospital and physician group acts as a managed care contracting agent for its owners; or

- Ancillary Joint Venture—The hospital and physician group form a joint venture entity for the purpose of operating one or more ancillary service lines (e.g., an ambulatory surgery center).

For a variety of reasons, MJM determined that it was important for it to remain in operation as a medical practice with ownership of its practice assets. Thus, the employment, foundation, and MSO models were not feasible because they would have involved a sale of MJM's assets to Swedish or an affiliate of Swedish. Furthermore, both parties desired a level of integration that eliminated the PHO and ancillary joint venture models. Accordingly, after much discussion, the parties agreed to an affiliation structure that is unique in the Seattle market—one that tightly aligns Swedish and MJM, while allowing MJM's physician-owners to retain significant participation in practice governance and a continuing ownership interest in the practice.

Under this affiliation structure, MJM remained intact as an operating medical practice without any change in its legal form or the ownership of its assets. Swedish formed a nonprofit, professional service corporation controlled by Swedish-employed physicians (Swedish PC), which made a substantial investment in MJM in exchange for a membership interest in MJM. MJM's governance was restructured to permit Swedish PC to have two Swedish-employed physicians on MJM's governing board, give Swedish and Swedish PC the types of reserved powers and initiation rights that are needed to ensure that MJM is operated in furtherance of Swedish's charitable purposes, and to permit the parties to contract jointly with payors and vendors, while at the same time reserving to the MJM physicians' control over the practice's clinical operations.

If in the future MJM's physician-owners and Swedish decide that it is mutually beneficial for Swedish or Swedish PC to become the MJM's sole owner, this structure does not preclude such a change in ownership. Such a transaction could be structured either as an asset purchase by Swedish or Swedish PC or as a purchase by Swedish PC of the MJM physician-owners' remaining membership

interests in MJM. Any such purchase would be for the fair market value of the assets or membership interests at the time of the purchase.

Healthcare Reform Implications

As a result of their affiliation, MJM and Swedish should be positioned well to deal with the challenges that healthcare reform is likely to present. As healthcare reform puts increasing economic pressures on providers, having the financial stability afforded by affiliating with a leading Seattle hospital system will be significant to MJM in enabling it to attract and retain physicians and to expand its services. In addition, this affiliation will make Swedish and MJM better able to adapt to new payment and clinical models that shift from the traditional fee-for-service system's quantity-based approach to provider reimbursement, to more value-based compensation methodologies such as accountable care organizations comprised of hospitals and physicians that provide coordinated patient care, are jointly responsible for achieving certain quality measures, and share in the cost savings that result from the quality improvements achieved.

Fraud and Abuse Considerations

As with any physician-hospital transaction, compliance with the Anti-Kickback Statute and Stark Law were important considerations in structuring the affiliation between MJM and Swedish. All agreements among MJM, Swedish, and Swedish PC were: (1) entered into on an arm's-length basis; (2) all remuneration provided for under those agreements was determined to be consistent with fair market value; and (3) each element of the affiliation transaction was structured to comply with applicable regulatory requirements. The parties retained an independent valuation company to provide a valuation of the MJM practice to determine the percentage interest in MJM that Swedish PC would receive in exchange for its investment.

Tax Considerations

MJM is a professional limited liability company that is treated for federal income tax purposes as a partnership. Swedish PC's investment in MJM was structured

as a capital contribution that did not result in a tax gain or loss to either party. By interposing Swedish PC as an investment vehicle, providing Swedish and Swedish PC with governance rights sufficient to ensure that MJM will be operated in a manner that furthers Swedish's charitable mission, and establishing that the economic aspects of the affiliation were consistent with fair market value, Swedish ensured that the affiliation would not adversely affect Swedish's tax-exempt status.

Conclusion

Swedish's president and chief operating officer, Cal Knight, observed that "[a]ll over the country, physicians and hospitals are working more closely together for the benefit of patients and the communities they serve." Knight views the MJM affiliation as a model for alignment that fits well within its efforts to "become more closely aligned with all of the private-practice physicians on [Swedish's] medical staff." MJM's chief financial officer, John Clarke, noted that the affiliation is "a natural step to take moving forward. With health reform coming, it's a good time to align ourselves with a hospital." He observed that the affiliation would enable MJM to take advantage of administrative efficiencies and access to capital that would better enable MJM to respond to anticipated reductions in Medicare and Medicaid payments as a result of healthcare reform.

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