Ambulatory Surgery Center
Acquisitions: Legal Challenges
Meeting Regulatory Requirements and Conducting Due Diligence to Minimize Compliance Risks

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HEALTH SYSTEM ACQUISITIONS OF AMBULATORY SURGERY CENTERS:

LEGAL ISSUES AND CHALLENGES

MEETING REGULATORY REQUIREMENTS AND CONDUCTING DUE DILIGENCE TO MINIMIZE COMPLIANCE

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The Transaction Process

• Non Disclosure Agreement
• Letter of Intent
• Definitive Documents
KEY NDA PROVISIONS

• Parties
• Definition of documents and information covered by the NDA
• Limitations on use
• Limitations on parties with access
• Term
• Obligations to return documents and information
LETTER OF INTENT

– Non-binding LOI
– Description of transaction
– Purchase price (based on FMV, or subject to FMV appraisal)
– Payment terms
– Additional transactions
– Due diligence
– Conditions to close
– Exclusivity/”No-Shop”
– Term/Termination
– Governing Law
– Deadline for response
Purchase Agreement – Key Deal Terms

• Description of purchase price
• Percentage acquired
• Order of dilution
• Reps and Warranties – Survival 1-2 years, with fundamental reps surviving indefinitely
  – Issue: Are healthcare reps fundamental?
• No Escrow, unless specific issues identified
• Indemnity Cap – high; could be up to purchase price
• Working Capital true-ups becoming more common
• Non-compete – 5 years
Operating Agreement – Key Deal Terms

• **Control**: Health System typically gets control of the board, but “super majority” protection for physicians by requiring their vote for agreed upon major decision. To a large extent doctors control business at the end of the day – “vote with feet”

• **Redemption prices**: Continue to be pushed down – ASC not a retirement vehicle

• **Sell equity to new doctors**: Requires super majority of docs

• **Dead weight issue**: Best remedy is “without cause” redemption

• **Non-compete**: During ownership and for two years thereafter
Management Agreements

• Long Term Agreements
• Management fees are trending downward (over 80% are 4%-6%)
• More pressure to justify fee
• Limitations: fee caps; becoming market to have fee percentages decrease as revenue increases
Legal Diligence

• Anti-kickback, Stark, state equivalents diligence (all financial relationships)
• Billing and Coding Audit
• Compliance with conditions of participation
• Licensure; Medicare certification; CON; Accreditation
• Payor issues, including out of network strategy
• Ancillary income (e.g. anesthesia)
STARK LAW “ISOLATED TRANSACTIONS” EXCEPTION

Applicable to “isolated financial transactions” such as a one-time sale of property or a practice.

1. “Remuneration” paid in consideration for the assets or interests is
   – Consistent with FMV
   – Not determined in a manner that takes into account volume or value of referrals by referring physicians or other business generated between the parties.

2. “Remuneration” is provided under an agreement that would be commercially reasonable even if the physician made no referrals to the entity.

3. There are no additional transactions between the parties for six (6) months after the isolated transaction, except for
   – Arrangements that are subject to another Stark exception (i.e., employment arrangement; lease arrangement, etc.)
   – “Commercially reasonable” post-closing adjustments that do not take into account volume or value of referrals or other business generated between the parties.
STARK LAW “INDIRECT FINANCIAL ARRANGEMENT

“Financial arrangement” is any arrangement involving remuneration, direct or indirect, between a physician and an entity.
STARK LAW “INDIRECT OWNERSHIP INTEREST”

An indirect ownership or investment interest exists if

- Between the physician and entity furnishing DHS there exists an unbroken chain of any number of persons or entities having ownership or investment interests.

- The entity furnishing DHS has actual knowledge of, or acts in reckless disregard or deliberate ignorance of, the fact that referring physicians have ownership or investment interests in DHS entity.
STARK LAW “INDIRECT COMPENSATION ARRANGEMENT”

An indirect compensation arrangement exists if

– Between the referring physician and the entity furnishing DHS there exists an unbroken chain of any number of persons or entities that have financial relationships between them
  • That is, there exists between each “link in the chain” either an ownership or investment interest or a compensation arrangement

– The referring physician receives aggregate compensation from the person or entity in the chain with which the physician has a direct financial relationship that varies with, or takes into account, the volume or value of referrals or other business generated by the referring physician for the DHS entity.

– The DHS entity has actual knowledge of, or acts in reckless disregard or deliberate ignorance of, the fact that the referring physician receives aggregate compensation that varies with or takes into account volume or value of referrals or other business generated by the referring physician for the DHS entity.
STARK LAW “INDIRECT COMPENSATION ARRANGEMENT”

If the financial arrangement between the referring physician and entity in chain with which the referring physician has financial arrangement is an ownership interest, then look to the compensation arrangement closest to the referring physician to determine if aggregate compensation paid to the referring physician varies with or takes into account volume or value of referrals or other business generated by the referring physician.
STARK LAW “INDIRECT COMPENSATION ARRANGEMENT”

Example:

- Physician
- Company A
- Company B
- Hospital “DHS Entity”
- Hospital Subsidiary

Ownership Interest

Ownership Interest

Contractual Arrangement

Look to compensation terms under contract between Company B and Hospital Subsidiary

- If aggregate compensation paid under the contract varies based on volume or value of physician referrals or other business generated by the physician, indirect compensation arrangement exists

Indirect compensation arrangement exception?
STARK LAW “INDIRECT COMPENSATION ARRANGEMENT”

“Stand in the Shoes”
A physician is deemed to “stand in the shoes” of his or her “physician organization” if the physician has an ownership interest in the physician organization.

“Physician organization” is defined as a physician, a physician practice, or a “group practice” that meets all of the criteria of a “group practice” under Stark.

“Physician practice” is not defined.

Financial arrangement between a DHS entity and a “physician organization” which has referring physicians as owners is therefore deemed to be direct financial arrangement between DHS entity and referring physicians for Stark purposes.
STARK LAW IMPLICATIONS

ACQUISITION OF ALL OR A PORTION OF OWNERSHIP INTERESTS OF REFERRING PHYSICIANS IN ASC BY HOSPITAL

• “Direct” financial arrangement between acquirer hospital and referring physicians
• Must meet “isolated transactions” exception
STARK LAW IMPLICATIONS

ACQUISITION OF ALL OR A PORTION OF OWNERSHIP INTERESTS OF PHYSICIANS BY WHOLLY-OWNED SUBSIDIARY OF HOSPITAL

“Indirect compensation arrangement”? Look to consideration paid to each doctor under purchase agreement

Indirect compensation arrangement only if “aggregate compensation varies with or takes into account the volume or value of referrals or other business generated by the referring physician.”
STARK LAW IMPLICATIONS

ACQUISITION OF ALL OF THE ASSETS OF THE ASC BY HOSPITAL ACQUIROR

“Direct financial arrangement”?  
– Only if the ASC entity is deemed to be a “physician organization” under Stark, and the physician owners therefore “stand in the shoes” of the ASC.

“Indirect financial arrangement”
– Only if consideration paid to ASC entity under purchase agreement varies based on the volume or value of referrals or other business generated by referring physicians for the acquiror hospital.
STARK LAW IMPLICATIONS

SUMMARY

1. Hospital acquires ownership interests from physicians:
   – Direct compensation arrangement, “Isolated Transactions” exception

2. Hospital subsidiary acquires ownership interests from physicians:
   – Indirect financial arrangement if aggregate consideration paid to physicians takes into account volume or value of referrals to hospital
   – If so, must meet “indirect compensation arrangement” exception

3. Hospital acquires assets of ASC, either directly or through subsidiary:
   – ASC entity not likely a “physician practice” for purposes of “stand in the shoes” regulation, so no direct financial arrangement between doctors and hospital
   – Indirect financial arrangement if purchase price takes into account volume or value of referrals or other business generated for hospital
   – If so, must meet “indirect compensation arrangement” exception
ANTI-KICKBACK STATUTE

42 USCS § 1320a-7b(b),

(1) Whoever knowingly and willfully solicits or receives remuneration, directly or indirectly, overtly or covertly, in cash or in kind

(A) in return for referring an individual to a person for the furnishing or arranging for the furnishing of any item or service for which payment may be made under a federal healthcare program, or

(B) in return for purchasing, leasing, ordering or arranging for or recommending purchasing, leasing or ordering any good, facility, item or service for which payment may be made under a federal healthcare program,

shall be guilty of a felony.
ANTI-KICKBACK STATUTE

42 USCS § 1320a-7b(b),

(2) Whoever knowingly and willfully offers or pays any remuneration, directly or indirectly, overtly or covertly, in cash or in kind to any person to induce such person

(A) to refer an individual to a person for the furnishing or arranging for the furnishing of any item or service for which payment may be made in whole or in part under a federal healthcare program, or

(B) to purchase, lease, order or arrange for or recommend purchasing, leasing or ordering any good, facility, service or item for which payment may be made under a federal healthcare program,

shall be guilty of a felony.
ANTI-KICKBACK STATUTE

“SAFE HARBOR” REGULATIONS

Office of Inspector General has published “safe harbor” regulations to the AKS.

These “safe harbors” address a variety of common arrangements, such as “bona fide” employment arrangements, space leases, equipment leases, and management and personal services arrangements.

If an arrangement is structured such that it meets all of the criteria of an applicable safe harbor, it is presumably “safe” from prosecution as a violation of the AKS.

OIG has not published a “safe harbor” similar to the Stark “isolated transactions” exception or any other safe harbor that applies to a purchase and sale of a healthcare facility.
ANTI-KICKBACK STATUTE

OIG GUIDANCE

In the absence of a safe harbor, we look to other OIG guidance for insight into deal structures that avoid or minimize AKS risk.

1. **OIG Advisory Opinions**
   - Interestingly, OIG has not issued any advisory opinions addressing the proposed acquisition and sale of all or substantially all of the assets of an ASC or 100% of the ownership interests of the ASC.
   - OIG has issued a number of advisory opinions addressing hospital/physician ASC joint ventures

2. **OIG Fraud Alerts**
3. **OIG Advisory Bulletins**
4. **OIG “Open Letters” to Healthcare Industry**
ANTI-KICKBACK STATUTE

ASSET ACQUISITION TRANSACTION

1. Purchase price should be FMV
   - OIG may “infer” that purchase price in excess of FMV is paid in order to induce referrals

2. Avoid “earnouts” or similar types of additional purchase price arrangements which may be affected by post-closing referrals of patients by selling physicians

3. Similarly, avoid escrows or withholds pursuant to which purchase price proceeds are released only upon satisfaction of conditions that may be tied, directly or indirectly, to future referrals or other business generated by selling physicians

4. Long-term “seller” financing may be risky
   - OIG may “infer” intent to induce selling physicians to generate business for ASC in order to ensure that purchaser has sufficient operating income to make payments under promissory note to seller

5. Ensure purchase price takes into account significant liabilities assumed by purchaser

6. Ensure purchaser acquires all assets included in FMV appraisal of the ASC
   - Example, all cash, accounts receivable, intangible assets of ASC valued as a “going concern”
ANTI-KICKBACK STATUTE

LESSONS FROM PARTIAL OWNERSHIP INTEREST ACQUISITIONS

– OIG Advisory Opinion 07-05 (June 17, 2007)

– Group of orthopedic surgeons holding 94% of equity in ASC proposed to sell 40% of equity to Hospital
ANTI-KICKBACK STATUTE

LESSONS FROM PARTIAL OWNERSHIP INTEREST ACQUISITIONS

− OIG issued negative Advisory Opinion

1) Acquisition of shares from existing owners, rather than investment in ASC
   • The proposed arrangement “would permit the Orthopedic Surgeons to realize a gain on their original investment in the Company.”

2) Not all owner/investors would sell a portion of ownership interests
   • “This raises the possibility that one purpose of the Hospital’s investment is to reward or influence a subset of Investing Physicians whose referrals of patients to the Hospital or to the ASC itself may be particularly valuable.”

3) Return on investment not directly proportional to amount of capital invested by each investor.
   • Hospital paid substantially more for units purchased from physicians than doctors paid for units; thus “the Orthopedic Surgeons would receive a higher rate of return on their remaining shares than the Hospital would receive on its newly-purchased shares.”
ANTI-KICKBACK STATUTE

LESSONS FROM ADVISORY OPINION 07-05

1) Purchase price for stock/units should be FMV (supported by FMV appraisal)

2) Acquisition of ownership interests from the business, with capital invested in the business, is best.

3) If interests are acquired from existing investors, or invested capital will be distributed to existing investors, then all owners should share proportionately in the opportunity.

4) Even out “disproportionate” LOI on ownership interests held by original investors vs. interests purchased by Hospital?
ANTI-KICKBACK STATUTE

SAFE HARBOR REGULATIONS

OIG has published safe harbor regulations for “Ambulatory Surgery Centers”

Protects four categories of ASCs:

1) Surgeon-owned ASCs
2) Single-specialty ASCs
3) Multi-specialty ASCs
4) Hospital/Physician ASCs
The “ambulatory surgery centers” safe harbor generally provides that payments made to an investor as a return on investment income is not considered “remuneration” for purposes of the AKS if

1) the ASC is a Medicare-certified ASC
2) its OR and recovery room space is dedicated exclusively to the ASC
3) investors disclose their investment interests in ASC to patients, and
4) all standards applicable to specific type of ASC are met
ANTI-KICKBACK STATUTE

HOSPITAL/PHYSICIAN ASC SAFE HARBOR

At least one investor is a hospital, all of remaining investors are surgeons or surgical group practices or “passive” investors, and the following standards are met:

1) Terms on which investment interests are offered are not related to referrals or other business generated by the investor for the ASC
2) The investor may not accept a loan from the entity or another investor to obtain the investment interest
3) The return on investors’ investment interests must be directly proportional to the amount of the capital investment
4) ASC and investors may not discriminate in treatment of patients
5) The ASC may not use space located in or owned by the hospital investor or equipment owned by the hospital unless under lease that complies with applicable safe harbor
6) All ancillary procedures performed in the ASC must be directly and integrally related to procedures performed in ASC, and may not be separately billed
7) The hospital may not include on its cost report or on any claim for reimbursement any costs associated with the ASC
8) The hospital may not be in a position to make or influence referrals directly or indirectly to any investor or the entity
ANTI-KICKBACK STATUTE

LESSONS LEARNED FROM ASC JOINT VENTURE ADVISORY OPINIONS

OIG has issued favorable Advisory Opinions relating to Hospital-Physician ASC Joint Ventures, AO 09-09 (July 22, 2009), AO 10-15 (August 31, 2010).

Proposed development of a new ASC as hospital/physician joint venture

Key take-aways from these Advisory Opinions:

1. OIG likes “safeguards” built into the transaction limiting the potential referrals from the Hospital to the ASC
   a) Hospital employees will not refer patients to ASC
   b) Hospital will “refrain” from actions requiring or encouraging members of medical staff to refer patients to ASC
   c) Hospital will not track referrals by medical staff to ASC
   d) Hospital will continue to operate its outpatient surgery service
ANTI-KICKBACK STATUTE

LESSONS LEARNED FROM ASC JOINT VENTURE ADVISORY OPINIONS

2. Ownership interests priced based on FMV appraisal of business, investors pay amount commensurate with pro rata share of investment.

3. If ASC is product of merger of existing facilities, or parties contributing assets other than cash, percentage of ownership interests issued to partners should be based on FMV appraisals of assets contributed, with cash contributions if necessary to cover any shortfall between value of non-cash contribution and desired ownership interest.

4. “Good fact” if Hospital investment allows it to provide service not previously providing, expand geographic footprint, enhance service offerings, etc.
ANTHI-KICKBACK STATUTE
NON-FINANCIAL PURCHASE AGREEMENT TERMS

1. Covenant not-to-compete. Generally acceptable if carefully and narrowly drafted
   – May prohibit sellers from owning, managing, etc. healthcare facility that provides outpatient surgery
   – May not prohibit sellers from doing surgical procedures at competing hospitals or ASCs
ANTI-KICKBACK STATUTE
ANCILLARY ARRANGEMENTS

1. Medical Director Agreements
   – Limited to reasonable and necessary directors
   – Comply with applicable Stark Law exception and Anti-Kickback Statute safe harbor

2. Facility Lease
   – Assume existing lease? If selling physicians hold ownership interests in landlord entity, “test” lease for compliance with “space rental” safe harbor
   – If lease does not meet criteria (rent above FMV; includes percentage based component), amend terms, or terminate and enter into new lease

3. Equipment Lease
   – If assuming equipment leases and selling physicians hold ownership interests in lessor, “test” lease for compliance with “equipment rental” safe harbor.

4. Professional Services Agreements
   – Anesthesia services? If selling physicians have ownership interests in anesthesia provider, query whether AKS risk warrants termination of agreement.
HOSPITAL-BASED REIMBURSEMENT

In order for hospital to bill for services provided in ASC as O/P department of hospital, the ASC must meet Medicare’s “provider-based” reimbursement rules.

1. **Licensure.** The ASC and the hospital must be operated under the same license.

2. **Clinical Integration.** The ASC and the hospital must be clinically integrated; i.e., ASC subject to clinical oversight and administration by appropriate hospital departmental supervisor and administrators and medical staff, medical records are integrated into hospital medical records system.

3. **Financial Integration.** ASC is financially integrated into hospital

4. **Public Awareness.** The ASC must be held out to the public as part of the hospital.
HOSPITAL-BASED REIMBURSEMENT

If the ASC is not located on the hospital campus, the following requirements must also be met:

1. **Ownership and Control.** The ASC must be operated under the ownership and control of the main hospital provider (i.e., ASC must be purchased by hospital entity).

2. **Administration and Supervision.** The reporting relationship between the ASC and the hospital must have the same frequency, intensity, and level of accountability that exists in the relationship between the hospital and any one of its existing departments.

3. **Location.** The ASC must generally be located within a thirty-five mile (35) radius of the hospital.

4. **Notice of Co-Insurance Obligation.** Must provide notice to beneficiaries of the patient’s co-insurance obligation; specifically, that patient will incur a co-payment for the outpatient “visit” to the ASC and a separate co-payment for the physician service.
CERTIFICATE-OF-NEED; LICENSURE

1. Licensure
   – State licensure rules.
     • Can the license be transferred on notice?
     • State re-survey on change of ownership and issue new license?
   – If operated under hospital license, notice to state licensing agency?

2. Certificate-of-Need
   – If ASCs are covered by state CON laws,
     • Ensure that ASC holds CON
     • Ensure that ASC may transfer CON
   – Require prior notice and approval? Or post-closing notice sufficient?
ANTI-TRUST

The Federal Trade Commission has been very aggressive in challenging proposed healthcare provider mergers and acquisitions that the FTC believes run a significant risk of impermissibly eliminating competition.

1. **Hospital Sector.** Phoebe-Putney Health System/Palmyra Park Hospital merger, Augusta, GA

2. **Physician-Practice Acquisition Sector**
   - Renown Health, Reno, NV, “roll-up” of cardiology groups in Reno and surrounding service area (December 2011)

3. **ASC Sector**
   - Reading Health System, Berks County, PA, proposed acquisition of Surgical Institute of Reading, 15 OR surgical specialty center (November 2012)
The Hypothetical Buyer Standard

• The fair market value (FMV) of a surgery center is the same regardless of purchaser – hospital system, management company, or private equity.
  – When purchasing a 100% interest, a hospital system might engage the former owners to assist in the prospective management of the center

• If the buyer is purchasing the management agreement, the agreement may be valued as part of the entire surgery center or separately
Issues Driving Value

• Higher multiples are paid for growth opportunities which are achieved through:
  – Improved reimbursement
    • Higher managed care reimbursement through better contracting
    • Opportunities within the market to add additional users / capacity
  – Operational efficiencies
    • Improved throughput allowing for additional utilization
    • Reduced supply cost through GPO
Other Value Drivers

• Case mix – buyers prefer a good mix of specialties with orthopedic surgery, ENT, and pain management most preferred

• Certificate of need

• In network reimbursement

• Transfer of assets
  – Is an appropriate level of working capital left in center or will the buyer have to infuse
Multiples of Earnings

• Buyers will generally look at multiples of trailing 12 month earnings before interest, taxes, depreciation, and amortization (EBITDA)
  – May vary if significant issues effected EBITDA in last 12 months
    • May look at multiple of adjusted EBITDA or revenue

• Debt is removed from business enterprise value to determine equity value.

• Equity value is multiplied by the block purchased to determine amount of consideration changing hands
Multiple Drivers

• Number of buyers within a market
• Access to capital
• Non-compete agreements
• Owners’ financial interest in center (i.e., amount paid for interest)