Dental Practice Mergers, Acquisitions, Divestitures and Affiliations

Conducting Due Diligence, Meeting Regulatory Compliance Requirements, Overcoming Integration Challenges

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1pm Eastern  |  12pm Central  |  11am Mountain  |  10am Pacific

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Agenda

1. Market Conditions and Process
2. Legal Structuring Considerations
3. Legal Due Diligence Issues
4. Regulatory Compliance Challenges
Market Conditions

• Market Composition Divisions
  – Large Consolidators
  – Medium/Regional Operators (3-15 locations)
  – Small Practices (1-3 locations)

• Payor Impact on Value

• Shift to DSO-supported practices
  – Estimated 18% of dentists up from less than 5% a decade ago
  – ADA estimated largest practices (over 500 employees) 1% of practices in 2002 to 2.8% in 2012

• Increase in private equity involvement and interest
Market Conditions – Potential Exits

- **Strategic Operators**
  - 1-2 Locations, Multi-Site Practices
- **Financial Acquirers**
  - 4+ Locations, $3mm+ EBITDA, $10mm+ Revenues
- **Mergers of larger practices?**
- **IPOs?**
Transaction Process

• Pre-Transaction Strategy
• Transaction Process (3-6 months):
  – Self-Diligence/Housekeeping
  – Restructuring (if needed)
  – Go to Market – Confidential Information Memorandum
  – Letter of Intent
  – Due Diligence
  – Negotiate Documents
  – Closing
Legal Structuring Considerations
## Practice Management vs Facility JV Structures

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<tr>
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<th>Practice Management</th>
<th>Facility Joint Venture</th>
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<tr>
<td><strong>Business Revenue:</strong></td>
<td>Professional Services Fees</td>
<td>Facility and Other (Non-professional) Fees</td>
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<tr>
<td><strong>Staffing:</strong></td>
<td>Employed/1099 Dentists</td>
<td>No Employed/1099 Dentists</td>
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<td><strong>Invokes Corporate Practice of Dentistry?</strong></td>
<td>Yes</td>
<td>No</td>
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<td><strong>CPoM/CPoD Affects Structure</strong></td>
<td>Requires DSO/PC Structure in many states</td>
<td>Permits Direct Ownership Joint Venture Structure</td>
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<td><strong>Examples in Other Sectors</strong></td>
<td>Physician Clinics Urgent Care Physical Therapy</td>
<td>ASCs Labs Imaging Dialysis Lithotripsy</td>
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### Regulatory Environment – Compared to Physician Practice Management (“PPM”)

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<th>DSO</th>
<th>PPM</th>
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<td>Newer</td>
<td>More Established</td>
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<td>Disruptive to existing business models</td>
<td>Already built into the fabric</td>
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<td>Largely Private Payors (other than Medicaid-focused businesses)</td>
<td>CMS and Private Payors</td>
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<td>Fragmented Industry</td>
<td>“P.E.A.R.” practices largely penetrated</td>
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Corporate Practice of Dentistry

- Structure of Entity Driven by State Corporate Practice of Dentistry and Fee Splitting Restrictions
  - Licensure of Professionals
  - Nominee Owners
  - Restrictive Covenant Agreement With Lead Professional
- State Laws
Basic DSO Structure

- Investor owns all or most of a DSO
- Professional Corporation (PC) owned by one or more licensed Dentists employs the Dentists
- Investor connection to the business is limited to an Administrative Services Agreement (ASA) which pulls through a fair market fee from the PC
Balancing Control vs Enforceability

- Enforceability of the ASA (the Investor’s primary tie to the Business)
  - Must avoid conclusion that DSO is really the owner of the PC (or controls clinical decisions) in violation of CPoD/CPoM laws
  - Challenges can come from different directions (State Regulators, Dental and Medical Boards, Former Sellers, Patient Class Action, Competitors or Payors)
- Elements of Control over the Business – Clinical vs. Business
- Sponsor/Lender/Buyer Conclusions Vary
- State-by-State Analysis of Risk – Not all states are created equal
Balancing Control vs Enforceability – Challenges

- Dental Boards Challenge Enforceability of the DSO Relationship
- Nominee Owner Walks Away with Business
  - Distressed Situations
- Local Dentists Walk Away
  - Claim Unenforceable Non-Competition Covenants
- Nominee Owner Regulatory Violations
  - Threaten Ability to Operate Business
- Lack of Corporate Control Over Business Collateral or Contracts
- Lack of Control Over the PC (i.e., an inability to replace the PC owner)
Balancing Control vs Enforceability – Potential Tools

- Long-term ASA with limited potential termination rights
- Share Transfer Restriction Agreements
  - Can limit voluntary transfer
  - Can force transfer in certain circumstances
- Termination Fees
- ASA Fee Structures (flat, percentage-based, cost-plus)
- Lien on Assets of PC
- “Friendly” Owners
- Diverse ownership (not one single owner)
- DSO owns all non-clinical assets (e.g., leases)
- PC guarantees/pledges PC assets for DSO debt/obligations
- Enforceable non-competes (against owner and/or employed dentists)
- Diverse Jurisdictions of Operation
- Other Contractual Tools
DSO Acquisition Structures – Stock Purchase

- Stock could be sold to Acquiring Practice or Owner of Acquiring Practice
- State Law determines whether a PC can own another PC
- Legal entity (at practice level) remains the same
DSO Acquisition Structures – Asset Purchase

- Clinical assets must be owned by professional entity
DSO Acquisition Structures – Considerations

- Are contracts assignable?
- Do you need to retain Target’s licenses, permits or provider numbers?
- Are there significant liabilities of Target you need to shed?
- Are there tax considerations that drive structure?
  - Short vs long term capital gains
  - Personal vs corporate goodwill
  - S-elections/S-corps
  - Built-in Gain on “hot” assets (A/R)
- Will any assets need to be retained or spun out?
Legal Due Diligence Issues
Diligence Issues for Acquirers

• Location of Assets and Collateral
• Non-Competes
• ASA Terms and Controls
• Billing and Coding Compliance
• Compliance with Commercial Insurance Contracts and Medicare/Medicaid Provider Agreements
• Relationships with Referral Sources
• Fraud and Abuse Compliance
Diligence Issues for Acquirers

- **Assets and Collateral Locations**
  - Hard (non-clinical) assets should be owned by DSO and non-professionals should be employed by DSO
  - Only licenses and billing agreements should be held by the PC
  - Collections run through the PC

- **Restrictions on Professionals**
  - Non-Competes and Non-Solicitation Restrictions
  - If “friendly” PC model, is the primary professional also an owner in the DSO?

- **Payor Contracts**
  - Assignability? How favorable is a particular contract?
  - Medicaid change of ownership
Diligence Issues for Acquirers

• ASA Terms Dictate Controls
  – What is the term of the ASA?
  – How is the management fee structured?
  – Does DSO have control over all non-medical decisions?
    Appropriate under state CPoD?
  – Power of attorney for billing/collections
  – DSO should have right to pledge A/R of the PC (if permitted by law)
  – What types of non-competes and solicitation restrictions are in place through the ASA?

• Specific Tax Issues
  – ASA as “Hot Asset”
Primary Regulatory Challenges

• Federal Stark Law
  – Designated Health Services – does it include dental?
  – Exceptions

• Federal Anti-Kickback Statute
  – Intent-Based Criminal Statute
  – Safe Harbors – Personal Services and Space/Equipment Lease

• State Fraud and Abuse Laws
  – Medicaid Fraud Laws
  – Fee Splitting Prohibitions

• HIPAA
  – Policies and procedures?
  – Compliance and security officer?
  – Past violations?
State Regulatory Updates
Teeth Whitening and Antitrust Law

North Carolina
• Supreme Court ruled 6-3 that N.C. restrictions on teeth whitening services violated antitrust law
• Restrictions on non-dentists restrained trade and board operating as industry participant
• *North Carolina Board of Dental Examiners v. Federal Trade Commission* (Feb. 25, 2015)

Connecticut
• 2d Cir. U.S. Court of Appeals upheld a Board rule that teeth whitening had to be provided by dentists
• Different result than Supreme Court reviewing similar rules
• Petition for cert denied
• *Sensational Smiles, LLC, dba Smile Bright v. Mullen* (July 17, 2015)
Registration of DSOs

• Texas Senate Bill 519 effective Sept. 1, 2015, requires DSOs to annually register with Secretary of State
  – Disclose: name and address of business and each dentist DSO is providing services to, names of owners holding 10% or more and list all services provided
  – SOS will then share this information with the Dental Board
  – Rule not yet finalized; for existing DSOs “unofficially” deadline to register is pushed back to Jan. 1, 2017; new once rule finalized

• Not unique, e.g., Kansas requires Dental Office Administrative Services Provider to register
Legal Proposals Focused on the DSO Model

• Washington House Bill 1514 (not enacted) would (a) restrict equity ownership and fee-splitting; and (b) restrict consulting and clerical services to fixed fees payment (i.e., not based on revenue), services may be cancelled at any time and no non-compete

• Texas Proposed Rule 108.74 (not enacted) would prohibit dentists from contracting with a DSO for certain non-clinical functions including management of equipment and back-office tasks

• Georgia proposed advertising rule amendment in 2014 (withdrawn) that involved dentists appearing to have an ownership interest in a practice when they do not
Best Practices for Compliance

- Establish Effective Compliance Policies and Procedures
  - Quality Care
  - Billing and Coding
  - HIPAA
- Designate an Independent Compliance Officer and Committee
- Train and Educate Staff
  - General Policies
  - HIPAA
- Review Compliance Program
- Reporting Channels
Billing and Coding Best Practices

1. Pre-screen insurance eligibility is to determine patient responsibility.
2. Provide only those services that are medically necessary.
3. Bill only services that are actually performed.
4. Bill at the correct service level.
5. Ensure all bills contain the:
   - Invoice number
   - Patient’s name
   - Date and description of services
   - Procedure codes
7. Provide training programs for billing and coding staff.
8. Conduct periodic internal billing and coding audits.
9. Hire consultant to conduct independent billing and coding audit.
10. 60 Day Overpayment Requirement for Medicaid
A HIPAA Compliance Top 10 List

1. Expressly-named privacy and security officers (can be the same person)
2. HIPAA policies and procedures – both privacy and security
3. HIPAA compliant authorization form for release of PHI
4. Sanctions policy, either referenced by or included in the HIPAA policies and procedures
5. Security risk assessment (initial and subsequent assessments)
6. Workforce training, with documentation of the materials and those who attended
7. Business associate agreements in place with business associates
8. Comprehensive list of business associate agreements
9. Notice of privacy practices, with appropriate posting/distributing, in facility and on websites
10. Breach response plan if not otherwise addressed in the HIPAA policies and procedures