

Implications of Adding a Partner to Your ASC

BY BRUCE MALLER



In this column, many authors have espoused the merits of the ambulatory surgery center (ASC). With our current health care crisis and reimbursement pressures, ASC ownership, particularly in vitreoretinal surgery, may be more attractive than ever. Over the past few years, ASC facility reimbursement has seen a steady increase, despite a general decrease in physician reimbursement. The reasons are complex and have been addressed in previous columns. A major reason, however, is the ASC lobbying effort in Washington by the Outpatient Ophthalmic Surgery Society (OOSS). I have been privileged to work with OOSS for several years and now serve as its Treasurer. The effort and dedication of the directors of this group, particularly Michael Romansky and Claudia McDougal, are unparalleled. OOSS has been tireless and unrelenting in championing the ASC cause successfully.

OOSS is more than an advocacy group—it is a one-stop ASC resource. I get questions about ASCs on a weekly basis and almost all the answers can be found on the OOSS Web site or in its many educational programs. If you have any interest in ASCs, I urge you to join OOSS. Support the organization as it has already supported you for many years.

As part of the OOSS educational program, Bruce Maller has written a fabulous four-part series addressing important and practical issues regarding ASC formation and management, particularly succession planning and valuation. Bruce is a highly regarded, well-respected practice consultant with a wealth of experience. A complete educational module may be found on the OOSS website: www.ooss.org.

— Pravin U. Dugel, MD

Owners of an ambulatory surgery center (ASC) must be able to attract and retain high quality surgeons in order to maintain long-term success. Offering an ownership opportunity can make your facility more attractive to a surgeon looking to get involved in an ASC.

On the surface, integration of a new surgeon partner would appear to be a simple proposition. Many ASCs, however, find that developing a rational and sustainable ownership model can be difficult. This is partly because it can be difficult to measure the economic benefits of a new owner to the overall profitability of the center. Additionally, the federal anti-kickback statute contains numerous provisions that affect the manner in which shares in an ASC are bought and sold. As a result of changes in the law and increased regulatory oversight, it is expected that scrutiny over ASC transactions will

increase in the coming years. Notwithstanding these trends, the key for ASC owners is to avoid situations in which shares are purchased or sold below fair market value.

It is recommended that centers develop an objective means to value ownership shares. Factors to consider include but are not limited to the following:

- historical cash flow;
- growth potential;
- payer mix; and
- partner stability.

In addition, when entering into a possible transaction, ASC owners should consider the merit of retaining an independent appraisal company with experience in these types of transactions. Regardless of how ASC owners approach this issue, it is always best to take a conservative stance in determining the per-share value.

BACKGROUND FACTS AND CIRCUMSTANCES

When admitting new partners to an ASC, the owners should review terms of similar transactions for the center. To follow are several questions to consider:

1. What were the facts and circumstances of previous transactions?
2. Was there a triggering event, such as death, disability, or retirement, that prompted the sale?
3. What are the redemption and associated valuation terms in the ASC's operating agreement?
4. Is there a formula for valuing shares, or is the share price determination subject to an appraisal methodology?
5. How was the price per share determined?
6. Have market conditions changed since the last transaction?
7. Have there been any changes in the operations of the center?
8. Has there been a change in the financial condition of the center?
9. Has there been a change in payer mix?
10. Has the scope of services changed?

Once these questions have been answered, the ASC owners should consider these answers within the context of the proposed transaction. By considering these factors, the parties to the transaction are more likely to meet the required fair-market-value test.

LEGAL AND REGULATORY ISSUES

What makes an ASC investment somewhat distracting is that although surgeons do not receive compensation for services rendered (earned from the professional fee component of the procedure), it is the personal commitment of surgeons that defines the center's success. This is, in part, why many surgeons often try to manipulate share ownership based on volume—an approach that has many risks and should be avoided.

Although it is outside the scope of this article to address the legal and regulatory considerations of investments in an ASC, one should carefully consider these aspects of the transaction.

As mentioned, provisions of the federal anti-kickback statutes will affect ASC transactions. Investors are encouraged to carefully study the “safe harbor” provisions that are associated with the Statute, as these provisions provide a good roadmap for investors to follow. Although the terms of a transaction may fall outside the scope of a safe harbor, this does not necessarily imply that the transaction terms are illegal. In addition to meeting the fair-market-value test, investors should also be careful to avoid the possibility that investor

returns are in some way tied to the value or volume of referrals one makes to a center. An experienced health care lawyer can provide guidance to the parties.

In a recent article in *Becker's ASC Review*, noted health care lawyer Scott Becker included eight ways ASCs should approach physician investment in an ASC.¹ The guidelines follow a number of the applicable ASC safe harbors:

1. Offer equal amounts of units per investor.
2. Offer units at the same price per unit.
3. Offer units at the then fair market value per unit.
4. Provide the investor with current financial statements and not their potential revenues.
5. Offer units only to physicians who will comply with the safe harbors—meet all tests and not just the one-third tests.
6. Clarify that the hospital or management company partner does not generate referrals for the center.
7. Review with investors the compliance requirements of the safe harbors.
8. An ASC may ask physicians why they choose not to use the ASC.

Although some of these suggestions may not have application in all cases, they do provide useful guidance for ASC owners.

MANAGING EXPECTATIONS

As is the case with any purchase and sale transaction, an objective is to find the right price and associated terms so that each party meets expectations. In the case of an ASC, a seller (an individual or an entity) strives to receive a fair return on investment as well as assuming the risk involved in developing or operating the facility. If the transaction is expected to have a dilutive effect, the seller should focus on whether the sale will enhance cash flows and/or the overall value of the center. It is helpful to prepare a forecast or model that illustrates the economic impact of the proposed transaction.

A purchaser of shares normally hopes to achieve quantitative as well as qualitative benefits from purchasing shares in an ASC. First, the buyer wants to receive a reasonable rate of return (ROI) on invested capital. This begs the question: What is considered a reasonable rate of return? In today's economic climate, most investors in private transactions involving ASCs are hoping to achieve a 25% to 35% return on invested capital. This return takes into account that most surgeon buyers are acquiring a minority interest in a private enterprise that does not offer liquidity. In other words, the shares cannot be bought or sold in the public market.

TABLE 1. FINANCIAL IMPACT OF ADDING A NEW PARTNER TO EXISTING ASC

	As Is	With New Partner
Number of Cases ¹	2,525	3,175
Operating Revenue ¹	\$1,908,130	\$2,424,230
Cost of Goods ²	\$381,626	\$484,846
Gross Profit	\$1,526,504	\$1,939,384
Operating Expenses ³	\$954,065	\$1,083,090
Operating Net Income	\$572,439	\$856,294
Number of Partners	4	5
Ownership Percentage Existing Partners New Partner	25% N/A	22.50% 10.00%
Net per Existing Partner	\$143,110	\$192,666
Net per New Partner	N/A	\$85,629
1. Per Table 2, it is assumed case volume for the new partner will be 500 cataracts and 150 YAGs, and total revenue of \$516,100. 2. Cost of goods is estimated at 20% of operating revenue. 3. Operating expenses are estimated at 50% of operating revenue in the as-is scenario and at 25% of the incremental revenue in the model with the new partner.		

TABLE 2. INCREMENTAL CASE VOLUME AND REVENUE FORECAST FOR NEW PARTNER

Procedures	Estimated Annual Volume	Medicare National Facility Fees	Total Estimated Revenue
66984 – Cataracts	500	\$962	\$481,000
66821 – YAGs	150	\$234	\$35,100
Total Operating Revenue			\$516,100
Cost of Goods ¹			\$103,220
Gross Profit			\$412,880
Operating Expenses ²			\$129,025
Estimated Net Profit from New Partner Cases			\$283,855
1. Cost of goods is estimated at 20% of operating revenue. 2. Operating expenses are estimated at 25% of operating revenue generated by the new partner.			

Generally, it is not a good idea for retiring surgeons to be allowed to maintain ownership shares following retirement from practice.

In addition to the financial returns, new surgeon investors are also hopeful of obtaining OR block time and a better environment for their patients. Although these benefits may not always be available, they are generally high up on an investor's list of preferences.

ILLUSTRATING THE FINANCIAL IMPACT

Table 1 provides a before-and-after summary model that illustrates the financial impact on the existing center owners as well as the new surgeon, allowing each party to assess the financial impact of the proposed transaction.

Table 2 provides a backup worksheet that illustrates the additional case volume and revenue forecast. Incremental costs are also illustrated.

In this example, although the existing center owners will suffer a dilutive effect on ownership percentages, the lower percentage ownership results in a higher distribution. This is due to the contribution being made by the new surgeon and the accompanying improved operating margins achieved by the center.

This exercise can prove helpful in assisting center owners in determining the appropriate number of shares to offer the prospective buyer.

OTHER CONSIDERATIONS

To follow are a number of other business issues that often come up when structuring these types of transaction.

A buyer wants to acquire additional shares in the future. These discussions can be challenging because the parties involved often do not have any track record to assess compatibility and behavioral issues as well as surgical skills and efficiency. This is why at the outset of the working relationship a trial period of 3 to 6 months is often recommended. If the relationship is working well, the ASC owners can always assess the feasibility of offering additional shares in the future; however, this is normally not guaranteed up front.

The ASC wants an assurance that a purchaser of shares will not perform cases at a competing facility. Noncompetition provisions are quite common in ASC operating agreements. An experienced attorney can provide appropriate guidance in this regard. There are

instances in which a prohibition against operating in another facility may not be practical: for example, where a health plan requires cases to be done in another ASC or hospital outpatient facility. Restrictions on operating at other facilities are very important in protecting the integrity of the facility.

The ASC wants protection in the scenario that a surgeon chooses to slow down or stops performing major surgery. This is a common challenge for ASC owners. The right answer starts with making sure the entity documents protect the integrity of the entity and do not violate the anti-kickback statute. The governing documents of the center should define what constitutes major surgery and the requirements for a surgeon to maintain active privileges. There could certainly be a trigger in the operating agreement that would require one to sell shares if no longer credentialed at the center. Be sure to solicit legal counsel on this issue.

A surgeon wants to retain ownership shares in the facility following retirement. Generally, it is not a good idea for retiring surgeons to be allowed to maintain ownership shares following retirement from practice. ASC owners will generally resent paying dividends to a nonproducing partner. There can be unique circumstances that might suggest a different solution; however, it is recommended that there be a defined time limit that should not exceed a few years. The key objective is to have a succession plan that will ensure continuity of the ASC for the next generation of surgeon owners.

There are unique aspects to every transaction that should be carefully evaluated. To facilitate the process, it is always best to have experienced health care legal counsel as well as a valuation prepared by an outside appraiser. This will assist in ensuring that the all parties involved can achieve their business objectives in a fair and compliant manner. ■

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1. Fields R. Healthcare Fraud Investigations Increase; Greater Caution Urged in ASC Share Sales to Physicians; 22 Dos and Don'ts on Selling ASC Shares. *Becker's ASC Review*. Available at <http://www.beckersasc.com/asc-transactions-and-valuation-issues/healthcare-fraud-investigations-increase-greater-caution-urged-in-asc-share-sales-to-physicians-22-dos-and-donts-on-selling-asc-shares.html>.