

## Ambulatory Care Facilities & Clinics

### *An Interesting Year for Surgical Facilities? Time Will Tell*

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Every year some 20 million surgical procedures take place at more than 5,000 ambulatory surgery centers (ASCs) across the country.<sup>1</sup> The fact that physician-entrepreneurs have grown single ASCs into formidable facilities or, in some cases, ASC development and management companies that often are involved in joint ventures with hospitals, has raised their profile in the health care debate. The increasingly complex interaction between physician groups and hospitals through acquisitions, joint ventures, clinical integration and more all impact such key issues as self-referral, reimbursement, credentialing and private inurement.

#### *A Year of Challenge and Change*

This past year has been one of both challenge and change for the ASC industry. However, with the impending rebound of the economy and numerous industry developments, the ASC industry is poised to perform well in 2010, including an anticipated uptick in transactional activity. On the individual ASC level, in spite of a slight decrease in demand, profits have grown as a result of the movement into ASCs of procedures historically required to be performed in the hospital setting, ASCs capturing additional revenue (for example, anesthesia and pathology), an active physician syndication market, and transactions in which the revenue from multiple facilities is consolidated into a single facility. Hospitals and health systems continue their interest in the ASC sector, both with start-up joint ventures as well as acquisitions. Despite the impact of the health reform legislation, the next 18 months should be good for the ASC sector overall.<sup>2</sup> Physician owned surgical hospitals, however, recently received a blow to the model. The legislation signed into law by President Obama, essentially, placed a complete moratorium on the development of new physician owned hospitals and placed limits on the ability of grandfathered facilities to expand.<sup>3</sup> Following are the key trends to look for during the coming 12 to 18 months.

#### *Consolidation in the Industry*

Significant consolidation in the ASC and surgical hospital industry may be expected during the coming months. There is general agreement among many industry leaders that several factors likely will lead to this trend. While there are several large companies in the ASC and surgical hospital space, the industry remains fragmented.

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Moreover, the struggling economy and the uncertainty created by the wrangling over health care reform held at bay many buyers during late 2008 and 2009. A number of stand-alone facilities and smaller ASC/surgical hospital companies have experienced drops in volume or reimbursement and are in search of capital and/or economies of scale. In addition, a number of companies backed by private equity sponsors may be anxious for some level of liquidity (if not complete exits) from their investments.

From a transactional perspective, new corporate buyers have emerged, including health systems, private equity-backed buyers and even existing ASC/surgical hospital companies that sat on the sidelines during 2009. A few historical corporate buyers, however, slowed down their acquisition strategies, due — at least in part — to the credit crunch. All of these factors will likely create an environment robust with consolidation activity over the next 12 to 18 months.<sup>4</sup>

### *Physician-Hospital Joint Ventures*

As part and parcel of the consolidation trend, significant increases in physician-hospital joint ventures are likely during 2010. The attractiveness of joint ventures for ASCs and physician owned surgical hospitals is substantial.

Steady and sufficient cash flow is critical to ASC operation. This requires strong managed care and commercial contracts that are not always available to small, standalone facilities, and physician owners of ASCs are beginning to accept the idea that a hospital partner with access to rich contracts may be essential to long-term survival. Most payors will treat an ASC as an affiliate of a hospital — thus allowing the ASC to benefit from the hospital's reimbursement rates — so long as the hospital holds at least a majority of the ASC's equity. As a result, we expect that hospitals will demand, and often receive, majority equity positions in these deals so as to allow the venture to take advantage of their managed care contracts.

Joint venture arrangements also give physician-owned ASCs greater access to the hospitals' own sources of capital, a major advantage for centers whose physician owners are often required to guarantee debt or meet capital calls.<sup>5</sup>

In addition to these ventures, we have seen some outright acquisitions of physician-owned ASCs by hospitals. Often, these facilities are converted to hospital outpatient surgery departments, in order to take advantage of higher hospital outpatient department (HOPD) rates, and accompanied by a management contract allowing the former physician owners to manage the facility.

### *Purchase Price and Valuation Trends*

Concomitant with the consolidation and joint venture trends should be an increase in purchase multiples and valuations. The last several years have seen a general downward trend in purchase prices. However, several recent transactions indicate an upward trajectory in acquisition price multiples. Recent indications are that control transactions may command implied EBITDA multiples as high as 6 to 7, net of funded debt. It is unclear, however, whether these levels will trend even higher and reach those seen in 2006 through 2008. Market multiples of the few publicly traded entities in the space will limit, somewhat, these prices.

*Health Care Reform and Physician Ownership of Hospitals*

There are approximately 180 physician-owned hospitals in the United States. Physician ownership of hospitals implicates the Stark Law through the creation of a financial relationship between the physician and the facility. However, a long-standing exception to the Stark Law — the so-called "whole hospital exception" — has allowed physicians to own hospitals and refer to them without violating the general prohibition. Since the early 2000s Congress and the Centers for Medicare and Medicaid Services (CMS) have attempted to slow the growth of physician-owned hospitals or eliminate physician ownership all together.<sup>6</sup>

These attacks on the model came to fruition in the health legislation signed by the President on March 23. The newly enacted law amends the Stark Law's whole hospital exception and, as a result, will halt new construction of physician-owned hospitals, and limit the expansion of "grandfathered" hospitals. There are some gray areas of the final law which may not be settled until the Department of Health and Human Services promulgates regulations based on the law, which will take at least 18 months. To expand operations, grandfathered hospitals would have to meet four requirements that virtually no physician-owned hospital currently meets. There are also additional requirements, such as disclosure of ownership, disclosure of physician coverage, ability to meet EMTALA standards and other financial disclosure requirements that are already in place.<sup>7</sup>

Despite the moratorium, the legislation (as amended by the reconciliation package) allows any hospital with physician investors and a Medicare agreement as of December 31, 2010, to fall within the grandfathering provisions of the statute. Thus, a small window of opportunity may exist for physicians and hospitals to enter into joint venture arrangements involving surgical hospitals. Many such arrangements may be structured as hospitals within hospitals or utilizing existing facilities in order to expedite the licensure, accreditation and certification processes. This uncertainty may provide opportunities for investors with the financial resources to bring certain of these deals to closure. In addition, physician investors may want to consider the "soft landing" of a hospital partner, or a large industry consolidator of these facilities, now that reform legislation has passed.

*Reimbursement Trends*

Ambulatory surgery centers are not immune from downward reimbursement pressure. The various changes to the ASC reimbursement structure proposed by Medicare in 2006 will take full effect by 2011. Under this new scheme, most procedures will be reimbursed at, approximately, 65 percent of HOPD rates (unless capped at physician office rates). It appears that certain specialties, such as orthopedics, ENT and general surgery, should fare well, while others, such as gastroenterology and pain management, will continue to be pressured. Moreover, there will be winners and losers, on a procedure-by-procedure basis, even within specialties. In addition to the above, insurers and certain state enforcement agencies are putting increasing pressure on ASCs and hospitals that provide out of network services to patients. For example, a major insurer in New Jersey has brought suit against several ASCs and hospitals alleging deceptive billing practices, violation of state laws related to waivers of co-pays and deductibles, among other things, in connection with their out-of-network billing strategies. This leverage is not likely to

let up. Thus, developers of facilities and buyers or others considering transactions with existing facilities are well advised to do their homework and understand specialty-specific reimbursement trends as well as the economics and risks attendant to a facility's out of network strategy.

## *Enforcement Actions*

A series of important recent and evolving developments in the health care compliance environment may put pressure on physician owned ambulatory facilities. The recent expansion of the False Claims Act and the further expansion of fraud enforcement included in health reform legislation will have a significant impact on the newest generation of physician-hospital integration initiatives. This comes in the wake of the ever-expanding connection being drawn by regulators between the quality of care and false claims liability. The focus on these matters is borne out by government activity, such as the formation of the Health Care Fraud Prevention and Enforcement Action team (HEAT), an interagency program of the U.S. Department of Justice (DOJ) and HHS designed to combat Medicare fraud. On January 28, 2010, Senator Grassley (D-IA) introduced the "Strengthening Program Integrity and Accountability in Health Care Act" (S.2964), which includes many of the fraud fighting initiatives from the health reform bills, including establishment of a self-disclosure protocol. At this point the bill has been referred to the Senate Finance Committee, which has yet to hold formal hearings. Meanwhile, however, the issue will continue to be a source of considerable stress for health care providers, and will consume resources that might otherwise be used to further more substantive compliance objectives.<sup>8</sup>

It is unquestioned that the stronger compliance requirements and construction restrictions for ASCs and other physician-owned hospitals represent a significant change for the industry. However, none of this spells an end to business opportunities represented by consolidation and other investment opportunities. Where there is change there is also opportunity.

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<sup>1</sup> Ambulatory Surgery Center Association, <http://ascassociation.org/faqs/faqaboutasc/>

<sup>2</sup> MWE 2010 ASC Symposium, 2/12/10, program brochure, <http://www.mwe.com/info/asc/2010ascbrochure.pdf>

<sup>3</sup> These rules are under Title VI, Section 6001 of the Patient Protection and Affordable Care Act. The provision is titled "Physician Ownership and Other Transparency – Limitations on Medicare Exceptions to the Prohibition on Certain Physician Referral for Hospitals." See "60 Hospitals Canceled Due to New Health Law," <http://www.mywellnessnetwork.com/tag/healthcare-patient-protection-and-affordable-care-act/>; see also Physician Hospital Association release at [http://www.physicianhospitals.org/documents/PHA\\_PR\\_3-22-10REV\\_000.pdf](http://www.physicianhospitals.org/documents/PHA_PR_3-22-10REV_000.pdf)

<sup>4</sup> Second paragraph, ASC Symposium, note 3

<sup>5</sup> Second paragraph, Roger **Strode** and Linas Grikis, "Why Are ASC Joint Ventures Increasingly Popular Today?" Outpatient Surgery Magazine, January 2010, [http://www.mwe.com/info/pubs/OS\\_0110.pdf](http://www.mwe.com/info/pubs/OS_0110.pdf)

<sup>6</sup> Roger **Strode** and Eric Zimmerman, "The Future of Physician-Owned Hospitals," MWE 12/3/08, [http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object\\_id/7388132d-81e0-474b-b2ee-67060a13d7fb](http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/7388132d-81e0-474b-b2ee-67060a13d7fb).

<sup>7</sup> Becker's ASC Review, " Ban on Physician-Owned Hospitals About to Become Law," 3/22/10, <http://www.beckersasc.com/news-analysis-hospital/business-and-financial/ban-on-physician-owned-hospitals-about-to-become-law-after-house-vote-on-reform.html>

<sup>8</sup> MWE, "Top Ten Health Law Issues for 2010," [http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object\\_id/b8fb48db-b688-46cf-8d46-fce4ca5742c0.cfm](http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/b8fb48db-b688-46cf-8d46-fce4ca5742c0.cfm)