

# The **Anatomy** of a Deal

A big-picture look at trends, situations and solutions in ASC equity sales.

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**D**espite the current economic downturn, management companies, health systems and other investors are cautiously optimistic that ASC deals will continue at a healthy pace in 2009. We've detailed some key legal and business issues commonly encountered in three ASC equity transactions: physician syndication, equity redemption and corporate investment.

## Attracting physician-partners

The sale of ownership interests to physicians who bring cases to the ASC will likely remain active as startups struggle to secure financing and existing facilities compete for surgical business in saturated markets. The key question in a physician syndication is the price at which ownership interests will be sold to a new physician-investor. Purchase price is typically based on the ASC's earnings before interest, taxes, depreciation and amortization (EBITDA) multiplied by a fair market value multiple, minus the ASC's long-term debt, then multiplied by the percentage to be acquired by a new partner.

A common misperception among physician-owners is that they should sell these interests at the same multiples that national ASC companies and health systems pay for a significant equity stake or

controlling interest — historically a 5 to 8 multiple, but likely trending downward. These figures, however, must be distinguished from the 2 to 4 multiple at which an ASC or its physician-owners might sell a minority interest to an individual physician.

For regulatory reasons, the purchase price must be at least fair market value and cannot be based on a physician's prior or anticipated surgical volume or the value of his referrals. But fair market value can create its own obstacles to successful syndication. The buy-in amount for an ASC with healthy earnings and little debt may be a significant financial hurdle for a younger physician, especially one whose other investments have taken a beating in the present market.

As a result, ASCs must consider ways to attract and accommodate new investors, perhaps by selling fractional interests or by arranging third-party financing through a lender familiar with the ASC's performance.

More recently, some ASCs have conducted physician syndications followed by a sale to a corporate investor. In this situation, the liquidity event that new partners enjoy from the corporate sale often lets them recoup a significant portion of their minority interest. This type of transaction, however,





can raise a number of regulatory concerns under the federal Anti-kickback Statute, and it is critical that a decent interval of time separates the syndication and sale.

You might also consider depressed buy-in valuations to make ownership more accessible. For example, your center embarks on a dividend recapitalization by borrowing to increase its long-term debt and distributing a substantial portion of the proceeds to its existing owners. With interest rates near historical lows, you can service the debt without much difficulty, the new partner can buy in based on a purchase price formula that deducts the center's additional long-term debt and the existing owners get some extra money in their pockets.

Alternatively, your center might provide its existing owners with a preferred distribution, while new investors and existing owners both would share in any profits above this distribution. Since the preferred distribution is senior to any distributions paid to new investors, the purchase price formula can be reduced accordingly.

Any ASCs formed as a limited liability company — clearly the investment entity of choice at present in the ASC industry — should also consider the issuance of profits interest, which lets new

partners participate in the ongoing profitability of the ASC, but not in the proceeds from a sale to a corporate investor.

Group practice ownership, as opposed to traditional individual physician investment, is another trend that has emerged in connection with physician syndication. Group practice ownership is when one or more medical group practice entities hold the ownership interests in the ASC.

This setup has two advantages. First, it may allow more flexibility in how ASC profits are allocated to physician-utilizers. Second, it may offer a useful basis for departing from the fair market value purchase price requirement if, as described above, the requirement presents a barrier to new investment.

Regardless of the method undertaken, a successful physician syndication transaction should be grounded in an operating, shareholder or partnership agreement that addresses decision making, redemption events, capital calls, restrictive covenants and other issues critical to investors' roles in the center.

## **Buying shares back**

A physician-partner who doesn't use an ASC, yet profits from the procedures performed there and has a say in how it's run, is a source of frustration to the productive physicians and an impediment to the potential sale of interests to a management company or health system. It is therefore important for you to be able to buy out the ownership of a "dead-weight doc."

ASCs' operating agreements generally set forth an agreed-upon mechanism for buying out physician-partners who no longer perform procedures at the ASC. Typical redemption events that would trigger such a buyout include a partner's death, disability or retirement.

But those aren't the only events that might result in a physician no longer utilizing the ASC or interfering with its operations. The relocation of a practice, failure to meet the one-third use and revenue test of the Anti-kickback Statute's ASC investment safe harbor, suspension of a medical

license and specified misconduct should also be included in such agreements. Some ASCs also include a provision letting a partnership vote out a member without cause.

Your operating agreement should define how the redemption price would be calculated. Unlike with a new investor's buy-in, the buyout is not required to be consistent with fair market value. However, you'll want to consider utilizing a buyout formula similar to the one used for purchases. Perhaps the formula will account for a further discount if the buyout relates to a "for cause" event. A consistent process can minimize potential fair market value issues that might arise if a new investor pays substantially less than what was paid to a departing investor around the same time.

Other methods for calculating redemption price include independent appraisal, an agreed-upon amount determined by your ASC's board and subject to change each year, or a return of the capital contribution (less any distributions received) made by the departing investor.

ASCs whose operating agreements do not specifically allow for a readily apparent resolution often find themselves scrambling for strategies to eliminate uncooperative deadweight physicians in the absence of a contractual right to do so. For them, one tactic that has proven effective is the "squeeze-out" merger. In this two-step process, the ASC's utilizers form a new entity in which they are the sole owners.



**UNDER SCRUTINY** The price of ownership shares must be at least fair market value and can't be based on a physician's prior or anticipated volume or the value of his referrals.

Then the existing ASC company and the new entity vote to merge, with only the utilizers receiving equity in the surviving entity.

### Corporate accounts

Partnership with a corporate investor may be an attractive opportunity to physician-owners. The investor is often willing to pay high multiples, physician-owners receive favorable tax treatment on the substantial purchase-price proceeds (currently a 15 percent capital gains tax rate, as opposed to the 35 percent ordinary income rate that applies to ongoing distributions) and the company brings business acumen and best ASC practices management that physicians may not have the time or inclination to address.

There are typically three aspects of a corporate investor transaction: First, the investor's purchase of a substantial equity interest in the ASC; second, the terms of the ongoing management agreement between the ASC and the corporate investor; and third, the terms of the governing agreement.

The equity interest percentage is often between 20 percent and 51 percent, although a number of

corporate investors are flexible and will consider purchasing a higher or lower percentage depending on each ASC's unique situation. With regard to ongoing management arrangements between the ASC and its corporate investor, management fees often range from 3 percent to 11 percent of the ASC's net revenue, depending on the scope of services being provided by the firm.

An even more critical deal point to the corporate investor, however, is its ability to exercise control over the ASC's operations. For some ASC management companies, that control may be essential in order to consolidate the ASC's revenue. For a not-for-profit hospital or health system, it will involve addressing certain tax exemption concerns. Whatever the reasoning, physicians selling interests to a corporate investor should generally expect to relinquish substantial control of their ASC.

These control issues will be handled through the terms of the governing agreement resulting from the transaction. But it is still important for you to negotiate certain minority rights prohibiting the corporate investor from making material decisions such as additional capital calls, the issuance of additional shares or the sale of your ASC without your consent. **OSM**

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