

A Guide to Private Equity Investment in Health Care

By Grace D. Mack and Michael F. Schaff

Health care entities are met with both significant challenges and new opportunities in the current environment. The decision to partner with a private equity firm has become an alternative strategy for consideration by many physician practices and health care providers. Other choices include remaining as an unaffiliated private practice or joining or joint venturing with a hospital. The choice is not a “one size fits all” and depends on many factors. This article provides a guide to the legal and practical issues for a health care entity to consider when reviewing potential private equity investment transactions.



1.1 The Rise in Private Equity Interest in the Health Care Arena

After the enactment of the Affordable Care Act, private equity companies' interest in investing in the health care sector intensified. In addition, U.S. health care annual spending recently reached \$3.8 trillion or \$11,582 per person.¹ As a share of the nation's Gross Domestic Product, health spending accounts for 17.7%.²

Private equity companies see value in health care and may offer the capital needed by some health care entities and professional practices to implement costly administrative functions such as data analytics and population health management tools. These investments may reduce costs and increase efficiency. In addition, the ever-expanding administrative duties of running a professional practice has added to practitioners' frustrations and increased their desire to reduce their administrative burdens, focus primarily on their professional practice, and secure an exit strategy for retirement.

1.2 Recent Health Care Private Equity Deals

Health care private equity had a banner year in both 2019 and 2020, closing out a noteworthy decade of activity.³ There were 709 private equity deals in health care in 2019 and the total disclosed deal value in 2019 reached \$78.9 billion, the highest on record.⁴

1.3 Chasing Unicorns

Health care was also a significant player in the "unicorn" class of 2020 with 11 health care start-ups reaching a valuation of \$1 billion or more.⁵ The exponential rise in demand for certain health care services and products during COVID-19 also affected private equity and venture capital investing trends. According to PitchBook, one health care startup, MDLive, a telehealth platform, raised \$75 million at a \$1 billion valuation.⁶

1.4 The Typical Private Equity Deal and Business Model

Although not all private equity arrangements are the same, private equity firms are typically structured as limited partnerships with each private equity fund a special purpose entity. Given the inherent risk and illiquidity of private companies, private equity investors are generally looking for meaningful internal rates of return after closing.

A. Multiple of EBITDA

The most common valuation method used in private equity deals in the health care sector is a multiple of EBITDA.

EBITDA or "Earnings before interest, tax, depreciation, and amortization" is the income derived from the company's operations before non-cash expenses, income taxes, or interest expense. EBITDA is viewed as a benchmark of a company's financial performance in terms of profitability without regard to certain non-operational expenses.

To determine the value of an enterprise using a multiple of EBITDA, a company's EBITDA is multiplied by an agreed-upon multiple. For example, if the company's EBITDA is \$2 million and the valuation multiple is 8 then the company's valuation is \$16 million.

Although valuation multiples are a useful methodology to determine the value of a company, the company's real valuation is much more involved than just multiplying the company's EBITDA by the valuation multiple. There are many factors that affect EBITDA and the multiple used in the valuation, such as the amount of rollover equity and post transaction compensation arrangements.

In the past, the range of multiples of EBITDA in the health care sector varied greatly, generally ranging from 3-14. According to the Bain Company, Inc. Global Private Equity Report 2018, (2018 Bain Private Equity Report),⁷

"retail health businesses with fewer than 10 outlets have been commanding multiples of around four to seven times EBITDA, those with 10 to 50 clinics are selling for seven to nine times, and some marquee assets with more than 50 clinics are trading in the low teens."⁸ Recent activity has indicated that multiples may even reach 15 or more.

Due to the complexity of the valuation process, parties in the private equity deal should engage experienced financial advisers to assist in the preparation and review of the valuation.

B. Rollover Equity

Many private equity deals include the issuance of rollover equity. In these instances, one or more of the physicians or health entity owners will roll over part of the proceeds or ownership interest into the new private equity manage-



GRACE D. MACK is the co-chair of the Healthcare Law Department of Wilentz Goldman & Spitzer, P.A. in Woodbridge, and a Shareholder on the Corporate Law Team.



MICHAEL F. SCHAFF is the co-chair of the Corporate and Healthcare Departments of Wilentz Goldman & Spitzer, P.A. in Woodbridge. Michael is a current member, and a former Chair, of the Editorial Board of New Jersey Lawyer and a Trustee of the New Jersey State Bar Association.

In CPOM states, such as New Jersey and New York, the CPOM doctrine generally prohibits a business entity, such as a private equity investor, from practicing medicine or employing a physician. To comply with the CPOM restrictions, the business people may form a management or administrative services organization (MSO) which may provide space, equipment, non-clinical personnel, supplies and management services to the professional practice.

ment entity. Depending upon the valuation given to the enterprise, the physician or other health care entity owners may be asked to retain between 10% and 40% of their ownership in the recapitalized entity.

Key Legal Issues

2.1 Beware of State Law Restrictions

A. Corporate Practice of Medicine Restrictions

In particular, state law must be reviewed for compliance with any applicable corporate practice of medicine (CPOM) restrictions. The CPOM has become an essential consideration in structuring transactions with private equity firms involving all types of licensed professionals. This analysis is state specific.⁹ The corporate practice of medicine doctrine essentially prohibits any person other than a licensed professional from owning or controlling or deriving the profits from a professional practice. The rationale for the doctrine is that individual physicians/licensees, not entities, should be licensed to practice the profession.

In CPOM states, such as New Jersey and New York, the CPOM doctrine generally prohibits a business entity, such as a private equity investor, from practicing medicine or employing a physician. To comply with the CPOM restrictions, the business people may form a management or administrative services organization (MSO) which may provide

space,¹⁰ equipment, non-clinical personnel, supplies and management services to the professional practice. The MSO may be set up as either a limited liability company or corporation that is owned in whole or in part by the private equity entity, or its affiliate, separate from the practice itself.

The MSO is paid a fee for providing non-clinical services to the medical practice. The fee should be fair market value and commercially reasonable for the services provided.

Management arrangements need to be carefully analyzed to ensure that these transactions are properly structured. In CPOM states, it is essential that the MSO not interfere with the professional's medical (clinical) judgment or otherwise exert control over the medical aspects of the medical practice. In certain CPOM states, such as New Jersey, the medical practice must be owned entirely by licensed professionals.¹¹

B. The Current CPOM Environment

As private equity and management arrangements become more common, regulation and enforcement in the coming years may increase. Recently, state courts and attorneys general have been focusing more on compliance with these CPOM laws. For example, in *All-state Ins. Co. v. Northfield Medical Center, P.C.*,¹² the New Jersey Supreme Court ruled that, based on the facts of the relationship, an MSO was the practical owner of the practice and thus the structure was a violation of the NJ CPOM. In

the *Matter of Andrew Carothers, M.D., P.C.*,¹³ a New York court held that a non-physician owned MSO was engaged in the corporate practice of medicine.

The corporate practice doctrine may apply to other types of licensed health care professionals. In fact, one very active area of private equity (PE) activity is dental practice management. Many states, including New Jersey, have corporate practice of dentistry restrictions similar or more restrictive than CPOM.¹⁴ As a result, there has been increased focus on arrangements with dental practice MSOs. For example, on June 18, 2015, the New York Attorney General and Aspen Dental Management Inc. agreed to an Assurance of Discontinuance after an Office of Attorney General investigation into ADMI's business practices which raised concerns under the New York corporate practice of dentistry restrictions.

2.2 Considerations as to the Structure of PE/Medical Practice transactions

It is important to consult with a tax adviser early in the development of a private equity transaction to ensure all decisions are made with a complete understanding of the tax consequences, including but not limited to, advice as the sale transaction and the equity rollover.

For example, if the transaction is structured as a stock/equity sale by the individual owner, the sale may be taxed at capital gains tax rate. This avoids double taxation. In addition, depending on the contractual provisions, the need to

obtain third-party consents may be avoided with a stock/equity sale. It may also enable the acquirer to retain payor contracts which are important to a health care entity. However, if a stock/equity sale is utilized, all liabilities will remain with the health care entity which becomes the responsibility of the acquirer. This is a significant factor in the health care industry given the risk that government and commercial payors make seek overpayment reimbursement in the future. This factor often drives the decision on the structure of the deal as an asset or stock/equity purchase.

2.3 Fraud and Abuse Laws: Anti-Kickback/False Claims Act Liability/Self-Referral Laws

In connection with a health care PE transaction, all compensation, investment and other financial arrangements with employees, contractors, practice owners and referral sources must be reviewed under the federal and state fraud and abuse laws.

A. Anti-Kickback Laws

PE arrangements in the health care sector must be structured to comply with the Federal Anti-Kickback (AKS).¹⁵ Similar to the Federal AKS law, many states also have prohibitions on kickback arrangements. State anti-kickback laws may differ significantly from the Federal AKS law. Therefore, PE deals must be carefully structured to comply with both federal and state AKS laws.

B. The False Claims Act

The Federal False Claims Act¹⁶ imposes liability on any person who submits a claim to the federal government that the person knows, or should know, is false. A provider who submits a bill to Medicare for medical services that they did not provide would be in violation of the FCA.

In addition, the FCA provides that private parties may bring an action on

behalf of the United States.¹⁷ These private parties, known as “*qui tam* relators,” may share in a percentage of the proceeds from an FCA action or settlement.

Similar to the federal laws, many states also have prohibitions on false claims.

In addition to fines and treble damages, penalties may include imprisonment and/or exclusion from other programs.

C. Self-Referral Laws

A careful self-referral analysis will have to be done in connection with each potential referral source to and from the health care participants in the private equity deal. Generally, the federal Stark Law¹⁸ prohibits physicians and other licensed health care providers from referring a patient for Medicare “designated health services” to a person or entity in which the physician or an immediate family member of the physician has a financial relationship, including ownership and compensation.

Many states, including New Jersey, have comparable self-referral laws.¹⁹ As with the state anti-kickback statutes, state self-referral laws may be much broader than the federal Stark Law.

2.4 Restrictive Covenants

The inclusion of restrictive covenants in private equity deals is an important deal consideration. Restrictive covenants may be contained in several different agreements in a private equity deal, including the acquisition agreements, physician services agreements, management services agreements, and employment agreements. Restrictive covenants include confidentiality, non-solicitation, non-interference and covenants not to compete. The enforcement of the covenants will depend on state law, the type of agreement, the parties involved and the scope and term. For example, a covenant contained in an acquisition agreement may be treated differently

than a covenant contained in an employment agreement; a private equity or management firm seeking to enforce a covenant with respect to a professional practice may be treated differently than a professional entity seeking to enforce the covenant with respect to a professional practice.

Many states will enforce covenants not to compete but limit the scope to a reasonable time and geographic restriction. In some cases, the courts will “blue pencil” the covenant to conform with the court’s determination of reasonableness.

2.5 Fee Splitting Laws

Private equity financial arrangements must be analyzed to ensure compliance with any state fee-splitting laws. Many states have stringent fee splitting laws that prohibit the sharing of fees obtained from providing professional health care services with non-licensees. Many of the fee splitting prohibitions are contained in the various licensing boards’ rules and regulations or in the definition of unprofessional conduct. For example, New York regulations²⁰ prohibit any fee-splitting arrangement whereby the amount received in payment for furnishing space, facilities, equipment or personnel services used by a professional licensee constitutes a percentage of, or is otherwise dependent upon, the income or receipts of the licensee from such practice. Thus, any arrangement in New York must not include any fee which is a percentage of the income or receipts of the practice.

2.6 Licensure Requirements

Licensed professionals and facilities in nearly every state are subject to stringent regulations governing many aspects of their operation. If an entity holds any licenses, certifications or accreditations, the transaction with the private equity firm may trigger change

of ownership, notification or other filing requirements.

As a result, in all private equity deals in the health care sector, licensure laws must be carefully examined to ensure that any type of collaboration between a licensed facility and other health care providers does not trigger any type of approval from the respective licensing agency. Parties should review all certificates of need, licenses, certifications, registrations, permits and accreditations held by the health care entity.

Certain activities provided by the private equity management entity may trigger license, registration or certification requirements under state law. These may include acting as an employment/ placement agency or third billing company or third-party administrator.

2.7 Securities and Antitrust Laws

If the transaction involves the issuance of securities or potential antitrust issues, it should be reviewed with securities and/or antitrust counsel for compliance with these laws.

2.8 Payor Related Issues

Another important factor is payor relationships and reimbursement. Managed care contracts need to be reviewed and may need to be renegotiated if the transaction is a triggering event under the payor arrangement. In some cases, Medicare and Medicaid provider numbers may be affected and payor notification is required.

Another payor related issue to be negotiated and included in the transaction documents is liability and indemnification for future payor recoupment relating to pre-closing services.

2.9 COVID-19 Considerations

The COVID-19 pandemic has affected PE transactions at every stage of the process. Parties must address COVID-19-related issues, such as the effect of the pandemic on provider revenue and the

evaluation receipt of stimulus funds under the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act), including loans under the Paycheck Protection Program and payments from the Public Health and Social Services Emergency Fund (HHS Provider Relief Fund), the Medicare Advance Program, and paid leave tax credits under the Families First Coronavirus Response Act.

Some Practical Tips

To avoid surprises in a PE deal, health care providers should engage in their own due diligence and regulatory review prior to negotiation with a PE firm. Issues which are identified for the first time during the private equity firm's due diligence review may result in delays in the transaction, impact the valuation and purchase price, and affect the credibility of the provider. Many of these issues, such as overpayments or regulatory concerns, can be addressed prior to the deal or disclosed to the private equity firm with a description of the affirmative steps taken by the provider.

Another useful tool for addressing some of the risk involved in larger private equity deals is the purchase of representation & warranty insurance. As a result of the increase in private equity transactions in health care, it is becoming more common place to consider representation and warranty insurance to absorb some or all of the risk of the investment. We expect this trend to continue and evolve. Although insurance will not replace indemnification, guaranties, escrows and holdbacks, it may serve as an additional risk management tool to decrease the risk in the deal.

The Ultimate Consideration

In addition to the practical and legal issues in this guide, the most significant consideration facing physicians and health care companies in their review of the available alternatives is their ability

to deliver sound patient care. All private equity arrangements with physicians, health care professionals and health care entities should be structured and operated to preserve the autonomy of the health care professionals in the practice of their professions and the delivery of patient care. ☞

Endnotes

1. CMS, National Health Expenditures Accounts (NHEA) 2019 Highlights
2. *Id.*
3. Global Healthcare Private Equity and Corporate M&A Report 2020, Bain & Company, Inc. (March 2020)
4. *Id.*
5. PitchBook, 2020's Unicorns Highlight Shift in Venture Capital Funding Trends, Priyamvada Mathur (November 6, 2020)
6. *Id.*
7. Global Private Equity Report 2018, Bain & Company, Inc.
8. *Id.*
9. The AHLA Corporate Practice of Medicine: A Fifty State Survey is available for purchase through the American Health Lawyers Association.
10. Note that the lease of a dental office in New Jersey by an MSO may implicate the corporate practice of dentistry under NJSA 45:6-19
11. NJAC 13:35-6.16(f).
12. *Allstate Ins. Co. v. Northfield Medical Center, P.C.*, 228 N.J. 596 (2017).
13. *Andrew Carothers, M.D., PC v. Progressive Ins. Co* (2017 NY Slip Op. 02614) Appellate Division, Second Dept.
14. NJSA 45:6-19
15. 42 U.S.C. 1320a-7b(b).
16. 31 U.S. Code § 3729
17. 31 U.S.C. 3730.
18. 42 U.S.C. 1395n(n).
19. N.J.S.A. 45:9-22.4-22.9
20. 8 N.Y. C.R.R. 29.1(b).