The New Private Practice

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By John D. Fanburg, Esq.

Attractive option for groups seeking to monetize their practices

Physicians and physician groups today have several options when it comes to positioning themselves strategically in today's evolving healthcare marketplace. One is to stay as they are and weather the industry's uncertain economics until the next phase of healthcare delivery, whatever and whenever that may be.

Another is to become part of a large single multispecialty group in an attempt to ameliorate the costs associated with running a practice. For the same reason, physicians are also contractually aligning with hospitals through a sale or professional service agreement.

Finally, physicians who are looking to monetize what they have built up over many years are seeking to do so by way of Wall Street through a private equity opportunity.

Group practices remain desirable targets for private equity firms, and activity in this area continues to be brisk nationwide. Several factors, however, will determine if the transaction will result in a mutually beneficial relationship.

Practice Size and Type Matter

Private equity firms are generally not interested in one- or two-practice medical groups. They prefer large entities with great revenue potential and an efficient infrastructure on which they can build through future acquisitions. Once a large platform is identified, opportunities for small practices may occur.

Several additional traits make large group practices attractive to private equity. Private equity firms are going to look primarily at profitability and geographic location. They are also keenly interested in the type of practice; not every practice specialty is in demand. Currently, urology, orthopedics, gastroenterology, dermatology, pathology, anesthesia, and emergency medicine are sought-after areas of interest.

The private equity firm is also going to consider the ages of the group's physicians. Are they at the end of their careers or at the beginning? What is the average age of all of the physicians in the group? Age is of particular concern because the private equity firm is not looking to pay upfront for physicians who have one foot out the door toward retirement. They also look carefully at the in-place infrastructure, the types of rates the practice has negotiated, and the practice's overall fees. What is its overhead percentage? Is it running lean and mean, or does it have too many staff who are non-producing?

Effects on Physician Compensation

From the physician's perspective, private equity may be an attractive alternative for those who have a remaining practice horizon of five to seven years. This makes sense because they can cash out and still practice medicine for a good while. Young doctors, with many work years ahead of them, may receive some cash upfront depending on how the deal is structured. However, they should be mindful that when private equity buys a practice, owner compensation typically decreases between 25% and 30%, so the upfront money may not be advantageous in the long run because their compensation is going to decline.

Physician compensation is also measured in productivity. The typical goal is to align everyone's compensation toward working hard and generating revenue for the practice. Many practices use Medicare's work relative value units (wRVUs) in this kind of compensation scheme. However, wRVUs don't take into consideration the practice's administrative functions—there needs to be money available to pay personnel who are involved in either medical staff leadership or medical practice leadership. This is usually negotiated with the rest of the deal parameters.

There are additional factors to consider, as well. In actuality, the private equity firm may only be in control for a short period of time. It may seek to "flip" the practice to another buyer within a two- to five-year period. Young doctors who have a long glide path to retirement could

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understandably be concerned about who their partners and bosses might be down the road as a result of the way these deals transpire and evolve over time.

Who Owns the Practice?

It's critically important to understand that even though a private equity firm "buys" your practice, it will never own it outright. In New Jersey and most other jurisdictions, only physicians can own medical practices. What private equity does is purchase the nonclinical assets of the practice, employ the nonclinical personnel, and lease these back to the medical practice. Depending on the jurisdiction, the medical practice group pays a fee to the company co-owned by the private equity firm and the physician sellers, and this fee constitutes the private equity company's income stream.

From a regulatory standpoint, not only can't non-physicians own a medical practice, but in some jurisdictions the management company is limited as to what it can and cannot control within the practice. The result is that all medical practice decisions must be left up to your physicians.

In addition, the private equity company does not pay 100% at closing in most transactions. Approximately 70% of the purchase price is paid at closing, and 30% is provided as "rollover equity" in the management company. It is important to note that notwithstanding the 70% cash payment, some amounts of the purchase price will be held back for indemnification retainage and working capital.

These terms are negotiable. Seller equity in the management company with the private equity firm is structured in the hope that there will be a second and third liquidity event over time. Frankly, this scenario is more a promise than a reality, but it does occur. We are still very early in the evolution of these transactions, so there hasn't been a plethora of secondary sales just yet.

All of the issues involved in a transaction, including valuation, operations, governance, and legal and regulatory matters, are complex and outside the scope of many physicians' experience (see "Legal Consequences"). The practice may want to consider retaining merger and acquisition (M&A) specialists who can provide valuable insight and help "run" the transaction, leaving physicians to focus on managing the practice and attending to patients.

Carefully Assess the Risk/Benefit Ratio

The transition from owner to employee is not always easy. Specifically, do not expect the culture that you have nurtured over the years to stay the same after a private equity sale. In the aftermath, many practices lose the common bonds, values, and behaviors that bound everyone together in the practice. In some situations, the physician sellers cease thinking of themselves as owners in the practice; they think of themselves as employees of the private equity firm. This, generally speaking, is not a good psychological perspective for the physicians to assume, and this affects the morale of the nonmedical staff, as well. Ideally, the private equity firm will work hard to ensure that the physicians feel like they are part of the ongoing ownership of the practice. Sometimes they are effective at this task, and sometimes they are not.

In exchange for this potential loss of authority over the practice and reduced income (for physicians with 10+ years of practice), several beneficial factors continue to fuel demand for private equity transactions from the physician side. When physicians have a short practice horizon, they can monetize what they have built up, take advantage of economies of scale, and may, ultimately, be part of a large footprint that creates leverage with private payers and local hospitals, depending on their specialty. These factors enable physicians to focus on what is ultimately most important—providing excellent patient care. And importantly, depending on the nuances of the deal, physicians can still have reasonable control over their destiny. GPJ

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Legal Consequences

Structuring the private equity deal in accordance with the laws of a particular jurisdiction is extremely important for your future success and ongoing ability to generate income for both your physicians and the private equity firm. Attorneys who engage in structuring these transactions, especially in New York and New Jersey where there is recent case law on the relationship between the management company and the medical practice, must ensure that the structure of the transaction is wholly compliant.

If the structure is not legally sound, then the insurance companies have a claim. If it is determined that the legal foundation of the transaction is not secure or in question, insurance companies can claw back the money that has been given to your practice over time. In an instant, your practice could be liable for treble damages—the return of that amount multiplied by three.