PHYSICIAN PRACTICE
NEWS

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# SELLING A MEDICAL PRACTICE
## Part II: The Sale Process

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Part I of this Article outlined the considerations related to the preparation of a practice for sale. Part II will provide the selling physician with a guide from the time the buyer begins the due diligence process through the structure of the sale, the preparation of the sale agreement and the closing of the transaction.

### PREPARING FOR DUE DILIGENCE

The Confidentiality Agreement. Prior to the beginning of the due diligence process by the buyer, the seller should require the execution of a confidentiality and non-disclosure agreement. The purpose of this agreement is to ensure that the information exchanged between the buyer and the seller during the due diligence process is kept confidential and not disclosed to third parties. In addition, the seller may not want employees or patients to be aware that a sale is being contemplated. Finally, it should not be forgotten that not all sale transactions make it to closing. This Agreement will typically address the following:

- A general description of the information to be disclosed and a time frame for the due diligence period;
- An agreement by the buyer to retain the information in confidence and not disclose it to third parties;
- An agreement by the buyer not to use the information to solicit patients or to compete with the seller should the transaction not close;
- An agreement by the seller not to negotiate with similar practices in the seller's geographic market area during the due diligence period;
- A period of time following the failure of the transaction to close during which the buyer will retain the confidentiality of the information; and
- An agreement by the buyer to return or destroy all information should the transaction fail.

The Letter of Intent. A letter of intent may be prepared to summarize the general terms of the transaction. The benefit of this approach is to surface major disagreements prior to incurring the costs of preparing the purchase agreement. Generally, letters of intent are not binding on the parties.

### STRUCTURING THE PURCHASE

Purchase transactions are typically structured as an entity purchase or an asset purchase.

The Entity Purchase. In an entity purchase, the buyer acquires the ownership interest of the physician in the entity that operates the practice. For purposes of a corporation, that would be the stock owned by the physician and for a limited liability company, the membership interest of the physician. Sellers prefer entity transactions because it may provide them with more favorable capital gains tax treatment. Buyers find entity transactions less desirable because they will be assuming the liability history of the entity as part of the acquisition. However, the fact that contracts with third party payers or favorable equipment or office leases will continue could offset some of that burden. Entity transactions are more common in situations where the acquisition is by an existing employee of the practice who may be more familiar and comfortable with the liability exposure of the practice. In this circumstance, a seller may also be willing to make concessions on the sale price given the existing relationship and the willingness to share the economic benefit of the tax savings.

The Asset Purchase. In an asset purchase, the operating entity sells the assets to an existing or new entity owned or formed by the buyer. Certain assets such as personal property of the physician or the accounts receivable of the practice and certain liabilities such as accounts payable

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or existing bank debt may be retained by the selling entity. The assumption is that the selling entity will collect the receivables and pay off the payables and the debt. The selling entity will then be dissolved and the net remaining assets will be distributed to the physician.

The Purchase Agreement. The purchase agreement is the binding and controlling document containing all the understandings of the parties. The general issues addressed are as follows:

1. Included/Excluded Assets. It is prudent to include a specific listing of assets included and excluded to avoid any misunderstanding. Intangible assets such as telephone numbers, trade names, service marks and domain names should not be forgotten.

2. Accounts Receivable. Sellers will normally retain ownership of the accounts receivables to avoid any valuation issues associated with the potential collectability of the receivables. The parties can agree on which of them will assume the responsibility for collection. It is often beneficial for the buyer to assume the responsibility so as to retain patient continuity. The buyer can receive a fee for the collection service. The parties should also decide the period of time during which the collection responsibility will continue and what will become of uncollected receivables.

3. Patient Records. The parties should agree on the timing and the process of notifying patients of the sale, the period of time after the sale the records will be retained and during which the seller will have access.

4. Liabilities. The parties should agree on which liabilities will be retained by the seller and which will be accepted by the buyer. Liabilities assumed by the buyer may include those that have a continuing benefit to the buyer such as real estate or equipment leases, equipment service contracts, service agreements for billing, staffing or accounting and vendor contracts. It should be noted that in an entity acquisition the buyer is not only assuming the scheduled liabilities but also the unknown liabilities. However, the purchase agreement can contain provisions that will cause some of that risk of the unknown to remain with the seller.

5. Employees. The parties should agree on the future of the seller's employees and the related costs of past employment. A buyer may or may not choose to offer a position to one or more of the employees of the seller. In an entity purchase absent provisions that cause the liability to remain with the seller, the buyer will assume the accrued employee benefit obligations. Employment taxes not paid or not remitted are also a peril of an entity purchase.

6. Purchase Price. The agreement should include either a stated purchase price or a methodology to be used to calculate an adjustable price. In either case, any offsets should be identified, such as prepaid expenses, malpractice premiums, rent or lease payments as well as any security deposits. An asset sale will require an allocation of the purchase price to tangibles and intangibles such as goodwill. (Physician sellers need to be aware, however, that if they are selling to a hospital or other entity to which they make referrals, the buyer will refuse to pay for goodwill in order to avoid Anti-Kickback issues. This goodwill issue is the result of the definition of "fair market value" under the Anti-Kickback Act. This issue does not typically arise when selling the practice to another physician group.) An entity purchase will not require such an allocation. In days past an adjustable purchase price would sometimes be included, made contingent on the level of business retained by the buyer. Under present compliance restrictions (Anti-Kickback Act, in particular), this is frowned upon by governmental authorities in sales of practices to a hospital and rarely, if ever seen. Under certain conditions, it may still be used in the sale of a practice to another physician or physician group. The approach to valuation must always be viewed very closely to make sure it complies with any applicable regulatory restrictions.

7. Payment of Purchase Price. The payment provisions of the agreement will address cash deposits, closing payments, continuing payments and any potential adjustments to such payments. The issue of collateral security for future payments as well as the escrow of funds to cover contingent liabilities should be addressed.

8. Representations and Warranties. The agreement will include representations and warranties of both parties including attestation to the right and authority to buy or sell, compliance with laws, payment of taxes, and the non-existence of litigation or undisclosed liabilities. These provisions will generally provide the basis for future litigation between the buyer and the seller if problems arise after the closing.

9. Post-Closing Responsibilities. The agreement may include post-closing responsibilities such as the seller's agreement to provide consulting or other services for a period of time.

10. Covenant Not to Compete or Solicit Employees or Patients. The agreement will include provisions aimed at preserving the value of what was purchased in the form of non-compete and non-solicitation restrictions. Those provisions are generally enforceable if reasonable in geography and duration.

11. Indemnification. The agreement will include mutual indemnification provisions for protection in the event of a breach of any representation or warranty. A point of significant negotiation will be the level and extent of indemnification of the buyer by the seller for undisclosed liabilities or litigation.

## REGULATORY ISSUES

There are various regulatory restrictions applicable to a sale transaction. These restrictions are designed to prevent buying and selling parties from (i) disguising payments to secure future patient income; (ii) generating an unfair competitive advantage; (iii) engaging in practices which are contrary to the tax exempt status of either party; and (iv) preserving the rights of patients.

• Fraud and Abuse. Fraud and abuse regulations are designed to prevent payment for referrals of patients in the form of direct remittances or a discounted purchase price. The Anti-Kickback Act provides criminal sanctions for any such direct payments or indirect benefits. The regulations promulgated by the Office of the Inspector General contain safe harbors for payments that are fair market value based. These regulations include office and equipment lease payments from the buyer to the seller and compensation payments for employment or professional services rendered after the close of the transaction.

• Stark Law. The Stark Law prohibits financial relationships between physicians and providers of designated health services and imposes substantial civil penalties for violation. A physician or immediate family member that has a financial relationship with a health services entity may not refer a Medicaid or Medicare beneficiary to that entity unless certain exclusions apply. The penalties for violations of the Stark and Anti-Kickback Act are very strict and harsh, so care must be taken to make sure the transaction is properly structured. With regard to Stark, note that the arrangement must fall squarely within an exception or it is in violation of the regulations.

• Tax Exempt Statutes. Where a hospital that is an Internal Revenue Code Section 501(c)(3) tax exempt entity acquires a physician's practice, payments must be for fair market value and be consistent with the hospital's charitable purpose. The acquisition must also serve the public and not inure to the benefit of an individual who is personally associated with the organization. The Internal Revenue Service can also impose intermediate sanctions, in the form of a fee or excise tax, on payments that exceed stated guidelines.

• Antitrust Laws. Federal and state antitrust and unfair competition laws could impact acquisition transactions. However, there are antitrust "safety zones" which may protect certain physician network joint ventures.

• Medical Records. There exist state laws which govern the time frame for retention of and providing access to medical records. A buyer can agree to act as agent for a seller in this regard. The Health Insurance Portability and Accountability Act of 1996 (HIPAA) privacy rules govern the transfer of patient information. However, there exists an exception for transfers pursuant to a business associate agreement between entities where the records are used for "health care operations." The American Medical Association also provides guidance in its Ethical Opinions.

The closing of the sale of a medical practice is a complicated transaction. The seller physician should not only be concerned with the realization of an economic benefit but also the pitfalls of non-compliance with the applicable statues and regulations. Utilizing a well-informed team of professional advisers will minimize the stress and facilitate the best possible outcome.

If you have questions about the issues addressed in this newsletter, or any other matters involving regulatory issues you may face as a physician, please feel free to contact the following attorneys:

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