

Insights

Private Equity Investment in Medical Practices Series: STEP 3 - Pre-Sale Diligence

September 29, 2022

By: Thomas N. Hutchinson and Brian M. Heaton

One time consuming (and potentially frustrating) part of any private equity transaction is pre-sale due diligence. Pre-sale diligence is an internal review of the “selling” practice. (For purposes of this article, we will refer to the practice as the “seller” even though the buyer may be making an investment in the practice and not buying it outright.)

Pre-sale diligence is intended to prepare the seller for the transaction process, which will include a detailed due diligence examination by the buyer. After the parties have entered into a Nondisclosure Agreement (**Part 1**) and have signed a Letter of Intent (**Part 2**), the buyer will expect to commence its pre-sale diligence in earnest. Ideally, for a seller to present itself in the best possible way, the seller’s side of the process could even start sooner. It is akin to cleaning up your home before guests arrive. This is the time to make any needed “repairs.” Done right, conducting pre-sale due diligence internally before a buyer starts its process can put the seller in a stronger position for the transaction and for its ongoing operations.

The pre-sale review typically includes a review of the seller’s books, board and owner meeting minutes and resolutions, organizational documents, permits and licenses, contracts, etc. Well maintained records will help facilitate the buyer’s diligence process and also demonstrates a “top notch” practice to potential buyers. The review is typically done by the practice’s administrative team, with significant involvement by outside advisors. If the seller uncovers any issues during its review, it can address the issue or prepare responses that may limit a buyer’s concerns. To the extent that any compliance issues are identified as part of the pre-sale diligence process, a seller should consider engaging outside counsel to assist with a formal investigation as to the extent of that compliance issue, under the protection of attorney-client privilege.

In addition to the areas described above, a pre-sale diligence review often involves the following compliance areas:

- **Payor Contracts.** Does the seller derive revenue from federal health care programs? Revenue from federal health care programs requires consideration of key health care fraud and abuse laws, including the federal Anti-Kickback Statute, the Stark Law, and the Civil Monetary Penalties Law. A buyer may also require a chart review to identify any potential issues with amounts charged to applicable payors.
- **Compliance.** Does the seller have a mandatory compliance agreement such as a corporate integrity agreement (CIA) or a voluntary program? Mandatory compliance agreements are often publicly available, either on governmental agency websites, attached to press releases from past settlements, or included on

the court dockets. Are there any related compliance concerns? Does the practice have an updated and effective compliance program that it actually uses?

- **Physician Contracts.** When physician employment contracts are applicable to the seller's activities, the buyer will likely pay particular attention to the methodology for calculating any incentive compensation to ensure that the methodology is consistent with fair market value. Are the agreements up to date and fully executed? Do they have valid restrictive covenants (such as non-competition and non-solicitation provisions) or are they based on "old law" and are no longer enforceable?
- **False Claims Act.** The diligence process should include an analysis of the seller's risk for liability under the federal and state false claims acts, including the risk of qui tam (i.e., whistleblower) lawsuits. Has the practice received any early indicators of such claims, including known compliance concerns or disgruntled employees raising issues?
- **HIPAA.** Diligence should encompass a review of the seller's compliance with HIPAA and HITECH Acts. Key questions include whether the seller has a HIPAA privacy officer and security officer and whether the seller has recently conducted a HIPAA security risk assessment. Buyer's counsel will also want to review the HIPAA breach logs, if any.
- **Facilities.** The diligence process will consider any facilities the seller owns or leases, whether those facilities are properly licensed, certified, or accredited, and whether any leases for those facilities comply with applicable healthcare fraud and abuse laws.
- **State Law.** It is important not to overlook state law issues. Of particular importance is whether there are state restrictions on the corporate practice of medicine. Also, some states impose limitations on the ability of licensed professionals or licensed entities to split fees.

As a seller conducts its pre-sale diligence, it can also address any items that might cause a delay in the buyer's diligence process. For example, it is common for parties to realize they do not have fully signed copies of certain contracts, including payor contracts, employment agreements, EMR agreements, supply contracts, employee benefit plan agreements, office and equipment leases, etc. To the extent any third party consents are needed to assign key seller contracts, those consents can cause delays in the transaction process and it is important to develop a plan for contacting those third parties as early as possible to not delay closing, but not so early that it creates risk for the seller.

In a traditional sale transaction, diligence is a two-way process. Although most of the focus is typically on the buyer's review of information about the seller, the seller should also investigate the buyer's ability to successfully finance and close the acquisition. Further, if the seller is receiving any rollover equity as part of its proceeds, "reverse" due diligence on the buyer will be important to verify the value of the rollover equity received. Finally, key employees of the seller will want to get information about the buyer's operations to ensure that they know what to expect as a post-closing employee of the buyer.

It is never too early to start pre-sale diligence. To discuss this process or any of your legal needs, please contact **Thomas N. Hutchinson**, **Brian M. Heaton**, or your usual Krieg DeVault attorney.

Disclaimer. The contents of this article should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult with counsel concerning your situation and specific legal questions you may have.