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Spotlight on Investments in Veterinary Practices and Veterinary Service Organizations

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Private equity investors and strategic buyers are entering the veterinary market because veterinary practices and veterinary service organizations ("VSOs") have become an increasingly popular investment opportunity. According to the Veterinary Services Global Market Report 2017, the market for veterinary services has been steady and is expected to gain the momentum to reach $200 billion in 2020, which will be a $46 billion growth since 2016.[2] The major opportunity for private equity investment in veterinary services lies in the room for consolidation and the transition to larger, group practices that offer a greater range of veterinary services.[3] Last year, corporations owned 15 to 20 percent of America's 26,000 pet hospitals, and consolidators are capitalizing fast.[4] Driving the veterinary service market's growth are a few primary forces: passion for pets, which is transforming pet health care to be more like human health care;[5] increased emphasis on preventative care and wellness for pets;[6] the growing field of pet insurance;[7] and expanding social and digital marketing and treatment options.[8] But as the veterinary and VSO model grows in popularity, so does regulation and scrutiny. Regulatory hurdles facing investors in veterinary practices are similar to hurdles facing dental and medical practices, and the legal solutions to these regulatory hurdles are structurally the same. Potential investors must be cognizant of regulatory structures and the variation among state and federal rules and regulations governing the practice of veterinary medicine when investing in this space.

This article surveys the VSO model and the driving forces behind the consolidation trends, and also addresses the hurdles and obstacles that may arise when investing in the veterinary space and undergoing consolidation to a VSO. Finally, this article provides examples of recent transactions and consolidation efforts within the VSO marketplace.

I. Background - Veterinary Practice Ownership Models

Following the model pioneered in the dental and physician practice industry, investors generally take one of two paths when investing in veterinary practices. The first is to directly possess an ownership interest in a veterinary practice, but this investment opportunity may be prohibited in some states due to corporate practice of veterinary medicine ("CPOV") laws and regulations. The second is to establish a VSO to provide non-clinical administrative services to the practice. In states where the corporate practice of veterinary medicine is prohibited, the veterinary practice remains a separate entity from the VSO and is owned by licensed veterinarians. The practice then enters into a services agreement for the VSO to

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[2] Sandeep, *4 Major Trends to Follow in the Veterinary Services Industry*, Market Res. (Feb. 27, 2017), https://blog.marketresearch.com/4-major-trends-to-follow-in-the-veterinary-services-industry; *Veterinary Services - US Market Research Report*, IBISWorld (Aug. 2017), https://www.ibisworld.com/industry-trends/market-research-reports/professional-scientific-technical-services/professional-scientific-technical-services/veterinary-services.html [hereinafter IBISWorld].

[3] Amy Or, *Who Could Be Next in Vet Deals?*, Wall Street J. (Aug. 21, 2014), https://blogs.wsj.com/privateequity/2014/08/21/who-could-be-next-in-vet-deals/; IBISWorld, *supra* note 2.

[4] Jason Clenfield, *The High-Cost, High-Risk World of Modern Pet Care*, Bloomberg, https://www.bloomberg.com/news/features/2017-01-05/when-big-business-happens-to-your-pet (last updated Jan. 9, 2017, 4:43 PM).

[5] Neil Howe, *How Generational Change Boosts the Roaring Pet Care Market*, Forbes (Jun. 20, 2017, 4:19 PM), https://www.forbes.com/sites/neilhowe/2017/06/20/how-generational-change-boosts-the-roaring-pet-care-market/#1c80c09f6ab1; *Veterinary Healthcare Market - Growth, Trends and Forecast (2017 - 2022)*, Mordor Intelligence (Dec. 2017), https://www.mordorintelligence.com/industry-reports/global-veterinary-animal-healthcare-market-industry [hereinafter *Veterinary Healthcare Market*].

[6] Howe, *supra* note 5; *Veterinary Healthcare Market*, *supra* note 5.

[7] Howe, *supra* note 5.

[8] Sandeep, *supra* note 2.

manage practice operations in exchange for a management fee. These agreements must leave clinical decision making and veterinarian-employment decisions to the practice. Although veterinarian practices' relationships with VSOs often vary structurally, many resemble this general configuration.

VSOs support the administrative, business, and financial aspects of veterinary practices by allowing veterinarians to focus on care and clinical operations while increasing the efficiency of the practice through professional office-management services. Typically, VSOs contract with veterinary practices to assist non-clinical operations**,** including accounting, human resources, office-space management, information technology, regulatory compliance, billing, and collections. VSOs frequently acquire the non-clinical assets of the practice, including equipment and goodwill. Further, if permitted by the state's veterinary regulations, the VSO will commonly employ the practice's technicians, assistants, and clerical employees. Owners of VSOs can vary; smaller VSOs may be owned solely by individuals, while larger VSOs may be owned by a mix of individuals, private-equity firms, stock plans, and the like.

II. Hurdles to Consolidation

Before closing any transaction in the veterinary space, VSOs, acquirers, lenders, and investors must be aware of several key considerations during the due-diligence process to ensure that the practice complies with all applicable state and federal laws. Analyzing potential pitfalls before closing will aid in identifying potential liabilities, as well as other issues that might negatively impact the value or otherwise hinder the VSO or veterinary practice. Below are a few key considerations to keep in mind when investing in VSOs or veterinary practices.

A. Corporate Practice of Veterinary Medicine

The VSO's ownership structure will be dictated in part by the CPOV restrictions in the state in which the VSO and the veterinary practice operates. This is nothing new to healthcare investors. It derives from the same tenet underlying corporate practice of dentistry and medicine prohibitions: only a duly licensed veterinarian can practice veterinary medicine. CPOV regulations affect whether and how veterinarians position themselves in legal structures with investors and other licensed veterinarians. Although veterinary-medicine restrictions may be less regulated than their professional counterparts,[9] investors must continue to exercise due diligence when considering investment arrangements.

Each state has its own unique CPOV restrictions. These are defined in statutes, regulations, case law, administrative rulings, attorney general opinions, and other regulatory guidance. Some states have imposed requirements that veterinary practices may only be owned and controlled by licensed veterinarians.[10] In these states, VSOs may establish a separate professional corporation with a state-licensed veterinarian as the sole owner, and the professional corporation employs licensed veterinarians to provide veterinary services. In these strict CPOV states, investors (unless a licensed veterinarian) cannot own a professional corporation. Instead, the buyer invests in the VSO. In states that do not have a strict or aggressive CPOV doctrine, licensed veterinarians may not be required to own the practice. In such states, a non-licensed veterinarian may be able to invest directly in the veterinary practice. But in all cases, the VSO must not interfere with the veterinarians' independent clinical judgment or patient care.

Similarly, state CPOV restrictions may also dictate the proper distribution of ownership assets between the VSO and the veterinarian. In some states, certain clinical assets (*e.g.,* client records) must be owned by a licensed veterinarian, while other assets may be owned by the VSO. For example, the Texas Board of Veterinary Medical Examiners regulations allow veterinarians to contract with VSOs to own or lease

[9] Clenfield, *supra* note 4 ("In contrast to human medicine, in which everything from the nurse-patient ratio to the caloric count of injections is mandated and overseen by a web of government agencies, veterinary medicine is largely unregulated."); Patty Khuly, *The 7 Top Challenges Facing Veterinary Medicine in 2017*, VETERINARY PRAC. NEWS (Feb. 27, 2017), https://www.veterinarypracticenews.com/the-7-top-challenges-facing-veterinary-medicine-in-2017/ ("[V]eterinary medicine is considered highly unregulated relative to most other industries and a veritable Wild West compared to human health care.").

[10] For example, Texas requires that owners in a veterinary practice be licensed veterinarians, although these veterinarians may be licensed in Texas or another jurisdiction. Tex. Occ. Code § 801.506. Kansas requires that a veterinary practice only be owned by natural persons licensed to practice veterinary medicine in the state of Kansas. Kan. Stat. § 17-2707, 17-2712.

facility space, medical equipment, instruments, supplies, insurance purchasing and claims services, and other similar assets for the practice of veterinary medicine.[11] Meanwhile, the VSO is permitted to access patient records as necessary to perform management functions. Regulations, however, prohibit such organizations from controlling or intervening in a veterinarian's practice of veterinary medicine.[12] Additionally, state CPOV restrictions may impose further requirements regarding the relationship between the VSO and the practice.

On the other side of the spectrum of corporate entity–veterinarian relationships are the professional's contractual relationships. State law may constrain how VSOs are compensated by prohibiting fee-splitting arrangements between veterinarians and non-licensed individuals or entities for referrals or reimbursement for services. For example, under the Principles of Veterinary Medical Ethics of the American Veterinary Medical Foundation ("AVMF"), splitting an attending veterinarian's fee with a referring veterinarian who has not rendered professional services is considered unethical behavior.[13] Further, AVMF principles state that veterinarians shall not offer or receive any financial incentive solely for the referral of a patient (*i.e.*, fee-splitting).[14] Also, while VSOs are often compensated through a management fee—usually a percentage of collections or revenue—some states may restrict percentage-based fees. If a VSO is prohibited from charging or decides not to charge a percentage-based fee, it may set the fee in advance by calculating the cost of each service it provides and adding a reasonable profit. While there is generally more flexibility when it comes to fees charged by a VSO as compared to similar management entities that provide services to medical or dental practices, a VSO should familiarize itself with the laws and regulations of the state in which it operates in order to ensure that its calculation of fees does not run afoul of any applicable fee-splitting regulations. Furthermore, state regulations may require approval or consent from the state veterinary board prior to entering into any management arrangements with VSOs. These regulations should be closely considered by any veterinary practice that plans to enter into a management services agreement.

B. Enforceability of Restrictive Covenants

VSOs should also consider the enforceability of restrictive covenants (*i.e.*, noncompetes or nonsolicitation clauses) against the practice sellers. If restrictive covenants are difficult to enforce or unenforceable under state law, the practice may not be able to prevent the veterinarian from competing with or soliciting business from the practice or VSO. The same is true if the restrictive covenant covers territory or duration that is unnecessary to protect the investor's business interests. The practice may also incur substantial legal fees in attempting to restrict these veterinarians from directly competing. Furthermore, investors should consider tailoring the restrictive covenants to reflect the specific veterinary practice involved. For instance, similar to dental practices, a growing trend for some veterinary practices is the use of mobile, full-service veterinary hospitals. Mobile practices can present challenges in constructing and enforcing reasonable geographic restrictions for noncompete or nonsolicitation clauses.[15] Investors should consider such geographic needs and ensure a mobile practice is not covered by a brick-and-mortar restrictive covenant, which may not provide the best protection for the practice and VSO from competitive activities by their veterinarians. The enforceability of such restrictive covenants is primarily a state specific analysis and care should be taken to review the applicable laws to craft a restrictive covenant that protects the business interests of the VSO and practice and will have a greater chance of being enforced.

C. Reimbursement Structure and Contracting Considerations

For investors, one appealing aspect of the veterinary market is the industry's self-pay nature—most veterinary practices simply do not rely on federal or

[11] 22 Tex. Admin. Code § 573.74

[12] 22 Tex. Admin. Code § 573.74; Tex. Occ. Code Ann. § 801.355.

[13] *Revisions Clarify Unethical Practice of Fee-Splitting*, AVMA (Jan. 1, 2011), https://www.avma.org/News/JAVMANews/Pages/110115g.aspx.

[14] *Delegates Discuss Ethics of Vendor Incentive Programs*, AVMA (Feb. 15, 2017), https://www.avma.org/News/JAVMANews/Pages/170301j.aspx.

[15] Lawrence J. Del Rossi, *Restrictive Covenant: Mobile Veterinarians and Their Vehicles*, Veterinary Prac. News (Nov. 7, 2017), https://www.veterinarypracticenews.com/restrictive-covenant-mobile-veterinarians-vehicles/.

private insurers. Thus, veterinary practices generally avoid issues that are a concern with medical and dental practices such as false-claims liability, exclusion from federal programs, billing and coding audits, federal payor program regulatory requirements, and out-of-network fee negotiations. Structuring the proposed investment becomes more complex if the practice receives reimbursement from federal health care programs or commercial payors.[16] Veterinary practices must nonetheless focus on the practice's key contractual relationships, as these may determine the structure of a potential deal going forward. For example, some contracts may require consent in order to assign the contract if all of the practice's assets are sold or assigned, but an equity sale may not trigger such provisions. In addition, the practice should be aware of situations where important contracts are entered between the individual veterinarian and a third party rather than the practice and a third party. In these cases, the practice could encounter difficulty if contracts are held by individual veterinarians and the relationship with that veterinarian sours. This could force the practice to continue working with an individual veterinarian despite a deteriorating relationship simply to maintain an important contract.

III. Recent Deals and Consolidation Efforts Involving VSOs

The veterinary market continues to trend toward the use of VSOs and shows signs of continued consolidation. Some recent deals exemplifying this trend are listed below:

1. In July 2017, OMERS Private Equity—the private-equity arm of OMERS, the pension plan for municipal employees in Ontario—announced that it would acquire a minority stake in National Veterinary Associates ("NVA"). NVA is the largest owner-operator of veterinary hospitals, pet boarding, and daycare centers in the United States, Canada, Australia and New Zealand, with more than 502 locations and more than 1,800 veterinarians. Areas Management, L.P., a private-equity investor, is currently and will continue to be the majority equity holder of NVA. The financial terms of the transaction were not disclosed.[17]
2. On January 9, 2017, Mars and VCA announced that they had entered into an agreement for Mars to acquire VCA in a transaction valued at approximately $9.1 billion.[18] In September 2017, Mars, Inc. and Los Angeles-based VCA Inc. announced the successful completion of Mars' previously announced acquisition of VCA and its 800 veterinary hospitals, animal-diagnostic-imaging company, and doggy daycare and overnight-camp franchise, Camp Bow Wow.[19]
3. In November 2017, WellHaven PetHealth purchased Aspen Animal Hospital in Aspen, Colorado, a local pet hospital that had been operating in Aspen for forty-six years. WellHaven PetHealth has also purchased two more veterinary hospitals, one in Happy Valley, Oregon, and another in Spring Glen, Washington. WellHaven PetHealth provides management services to veterinary practices and is privately held, with investors including Capricorn Healthcare.[20]

These deals not only present a window into the emerging veterinary-practice market, but they also demonstrate VSOs' consolidative effect on the market in general. Many features of VSOs—and the veterinary-practice market—make VSOs particularly appealing consolidation options. But, as always, investment barriers and potential pitfalls must be taken into account. As a growing field, VSOs may ultimately provide a solid market for investors.

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[16] Yale H. Bohn, *Private Equity Investments in Health Care Practices*, Lexology (Aug. 28, 2017), https://www.lexology.com/library/detail.aspx?g=4d9fd054-eeaf-4f74-a714-f5fd328537fb.

[17] *OMERS Private Equity Acquires Minority Stake in National Veterinary Associates*, Nasdaq GlobeNewsire (July 6, 2017), https://globenewswire.com/news-release/2017/07/06/1039623/0/en/OMERS-Private-Equity-Acquires-Minority-Stake-in-National-Veterinary-Associates.html.

[18] *Mars, Incorporated Completes Acquisition of VCA Inc.*, PRNewswire (Sept. 12, 2017), https://www.prnewswire.com/news-releases/mars-incorporated-completes-acquisition-of-vca-inc-300517872.html.

[19] Michael Neibauer, *Mars Inc. Buys 800 Animal Hospitals for $9.1B*, Wash. Bus. J. (Sept. 13, 2017), https://www.bizjournals.com/washington/news/2017/09/13/mars-inc-buys-800-animal-hospitals-for-9-1.html.

[20] Erica Robbie, *Aspen Animal Hospital Under New Ownership of WellHaven PetHealth*, Aspen Times (Nov. 17, 2017), https://www.aspentimes.com/news/aspen-animal-hospital-under-new-ownership-of-wellhaven-pethealth/.