

McGUIREWOODS

Private Equity Investments in Orthopedic Practices: We've Got Your Back!

HOLLY BUCKLEY, PARTNER

312.849.3687 | hbuckley@mcguirewoods.com
77 West Wacker Drive, Suite 4100
Chicago, IL 60601-1818

TIMOTHY FRY, ASSOCIATE

312.750.8659 | tfry@mcguirewoods.com
77 West Wacker Drive, Suite 4100
Chicago, IL 60601-1818

GRETCHEN TOWNSHEND, PARTNER

312.849.8237 | ghtownshend@mcguirewoods.com
77 West Wacker Drive, Suite 4100
Chicago, IL 60601-1818

AMANDA ROENIUS, ASSOCIATE

312.849.8157 | aroenius@mcguirewoods.com
77 West Wacker Drive, Suite 4100
Chicago, IL 60601-1818

www.mcguirewoods.com

McGuireWoods marketing communications are intended to provide information of general interest to the public. Marketing communications are not intended to offer legal advice about specific situations or problems. McGuireWoods does not intend to create an attorney-client relationship by offering general interest information, and reliance on information presented in marketing communications does not create such a relationship. You should consult a lawyer if you need legal advice regarding a specific situation or problem.

Private equity firms have invested in many sectors of the healthcare industry—from dermatology to ophthalmology/optometry, to urgent care. Unlike their industry peers, however, orthopedic practices remain largely untouched from outside investment, and such fragmentation is garnering significant interest from investors. With a high demand for services, increased case movement to outpatient venues, and high-value ancillaries, the enthusiasm for orthopedic practice investment should continue to swell, sparking a flurry of investments during 2019 and beyond.

Recent Investments

The orthopedic space has not, to date, seen as much consolidation and private equity investment as other specialties, positioning it for a surge of private equity transactions in the coming years. Recent orthopedic transactions include:

Associates in Orthopaedic Surgery (AOS) and OrthoIllinois. OrthoIllinois and AOS, two bone and joint providers in northern Illinois, joined forces as of June 1, 2018. Established in 1967, OrthoIllinois serves the northern Illinois region in multi-specialty orthopedics offering a full range of bone and joint care, as well as physical therapy, MRI and custom orthotics, and an outpatient surgery center.

Atlantic Street Capital and OrthoBethesda. In September 2018, Atlantic Street Capital partnered with OrthoBethesda, a full-service provider of orthopedic services in the greater Washington, DC area.

Candescent Partners and Southeastern Spine Institute. In April 2017, Candescent Partners announced its partnership with Southeastern Spine Institute, one of South Carolina's largest medical practices.

Frazier Healthcare Partners, Princeton Ventures, and The CORE Institute. In January 2017, Frazier Healthcare Partners and Princeton Ventures partnered together, announcing their investment in The CORE Institute. The investment provides The CORE Institute with the growth capital necessary to expand its musculoskeletal care networks.

Lorient Capital and Atlantic NeuroSurgical Specialists. Atlantic NeuroSurgical Specialists, which is based in Morristown, New Jersey, has eight neurosurgeons, and provides care for brain and spinal issues outside New York City, received funds from Lorient Capital in October 2018.

Rothman Orthopaedic Institute, NueHealth and Muve Health Joint Venture. In February 2019, Philadelphia-based Rothman Orthopaedics Institute, one of the country's largest orthopedic practices, announced a partnership with Leawood, Kansas-based NueHealth, an Ambulatory Surgical Platform company, and Denver, Colorado-based MUVE Health, a developer and operator of total joint and spine centers. The companies are not merging, but are, instead, forming a joint venture to expand and integrate their respective outpatient surgical platforms.

Surgery Partners and National Surgical Healthcare. In May 2017, Surgery Partners, Inc. announced that it had entered into a definitive merger agreement with National Surgical Healthcare to create an enterprise of approximately 125 surgical facilities across 32 states, with an emphasis

in musculoskeletal programs, including orthopedics, pain, and spine. Funding was provided, in part, by Bain Capital Private Equity.

Varsity Healthcare Partners and Orthopedic Institute. In November 2017, Varsity Healthcare Partners entered into a strategic partnership with the Florida-based Orthopedic Institute in an equity recapitalization transaction. The transaction was designed to grow The Orthopedic Institute's footprint through future acquisitions and recruitment.

Market-Dynamic Considerations

There are numerous characteristics that make orthopedic practices attractive to investors. Investors who are evaluating orthopedic opportunities should consider the following market dynamics.

Opportunities in Outpatient Care Settings

Orthopedic practices and physicians have long invested in ambulatory surgery centers (ASCs). ASCs are an attractive alternative to hospitals for surgical procedures for many reasons, including but not limited to cost containment and better access to care for patients. Payors, recognizing these benefits, continue to encourage efficient and effective treatment in outpatient settings. For example, the Centers for Medicare & Medicaid Services (CMS) has consistently approved more procedures that can be done in an outpatient setting, particularly orthopedic procedures. Partnering with orthopedic practices often includes the opportunity to directly invest in ASCs.

Reimbursement

Orthopedic practices often enjoy an advantage in terms of reimbursement because common procedures are generally reimbursed well by insurers. Further, similar to other attractive healthcare sub-sectors, such as the dental and dermatology spaces, orthopedic practices often provide elective procedures, which are not subject to discounts by insurers because the patient pays in cash.

Demand for Services

Orthopedic care is among one of the fastest growing segments in the healthcare industry, with orthopedic conditions generating more than 137 million visits to physicians' offices, hospitals, outpatient clinics, and emergency departments on an annual basis.¹ Favorable demographics, such as the significant decrease in the uninsured patient population as a result of the Affordable Care Act, present opportunities for potential increases in the volume of orthopedic services. In fact, the U.S. population currently spends approximately \$50 billion to treat back pain alone.² Further, as the nation's population continues to age, so too does the need for orthopedic services. By 2030,

¹ See Patrick Krause, MHT Partners, *Why PE Firms are Buying Orthopedic and Ophthalmology Practices* (Aug. 3, 2017), available at <https://www.pehub.com/2017/08/why-pe-firms-are-buying-orthopedic-and-ophthalmology-practices/#>.

² See Am. Chiropractic Ass'n, *Back Pain Facts and Statistics*, available at <https://www.acatoday.org/Patients/Health-Wellness-Information/Back-Pain-Facts-and-Statistics>.

the demand for hip replacements is estimated to grow by 174%, and the demand for total knee replacements is estimated to grown even higher—by 673%.³

Ancillary Services

Orthopedic practices are also attractive to investors due to the utilization of multiple ancillary service lines, including but not limited to imaging, physical therapy, durable medical equipment, urgent care, and, as mentioned above, ASCs. Providing these ancillary services offers the ability to gain additional revenue and serve as a “one-stop-shop” for patients, facilitating access to care and consumer convenience. As discussed in more detail in Section III, the structure of ancillary services and arrangements should be thoroughly reviewed and analyzed for compliance with applicable laws.

Alternative Payment Arrangements

Throughout the past several years, orthopedic practices have increasingly participated in bundled payment and risk-sharing programs for common procedures, such as total knee and hip surgery. Under bundled payments, payors generally negotiate a single, global fee, inclusive of post-operative care, surgery, anesthesia, the facility fee, etc., which places the risk of cost containment on the providers rather than the payors. According to CMS, “[r]esearch has shown that bundled payments can align incentives for providers . . . allowing them to work closely together across all specialties and settings.”⁴ The ultimate goal of this payment model is to lower spending and improve overall care. While most of these programs are optional, especially negotiated arrangements with private payors, CMS has mandated a few bundled payment/risk sharing programs for certain orthopedic procedures in a hospital setting. While implementation of these payment programs in the orthopedic sector has, overall, been met with success, investors should carefully diligence these models to ensure the bundled payment systems are properly established within a defined market, with a dedicated team, and that proper data collection and analysis has been conducted to ensure financial viability. Another interesting reimbursement trend in this space is direct-to-employer contracting. Direct contracting allows employers with self-funded plans to negotiate rates with providers. This is attractive in areas like joint replacements where episodes of care are contained and are at high-cost.

Physician Appeal

Physicians are aware that the healthcare industry is changing and that size and scale matter. As such, while many orthopedic surgeons, who, as a group, are generally more protective of their independence than other specialties, may have historically viewed the sale of a practice as a loss of independence, there is a recognition that the industry is now shifting to view private equity investment as necessary to maintain independence and increase profit. Further, as is the case in numerous other specialties, the number of retiring orthopedic surgeons outpaces physicians who are beginning their careers in this space, setting the stage for innovative delivery models. Notwithstanding, competition in the market is prevalent, and investors are not the only groups with

³ See S. Kurz, K. Ong, E. Lau, F. Mowat, & M. Halpern, *Projections of Primary and Revision Hip and Knee Arthroplasty in the United States from 2005 to 2030*, available at <https://www.ncbi.nlm.nih.gov/pubmed/17403800>.

⁴ *Bundled Payments for Care Improvement Initiative*, CTRS. FOR MEDICARE & MEDICAID SERVICES (Sept. 30, 2013), available at <https://www.cms.gov/newsroom/fact-sheets/bundled-payments-care-improvement-initiative>.

an eye on investment in orthopedic practices—for example, hospitals have long tried to break into the space by acquiring key orthopedic groups. Orthopedic surgeons tend to have a strong entrepreneurial disposition and have frequently capitalized on opportunities to invest in ancillary services such as ASCs and hospitals. PE firms should, in evaluating these partnerships, tap into that entrepreneurial spirit and work to advance physician alignment strategies, not only through compensation but cultural fit within a larger platform, to garner physician approval and interest in investment.

Emerging Areas: Regenerative Medicine

The orthopedic space is ripe for continued innovation and development. On both the medical device side (e.g., implants and robotics) and the provider side, there is constant growth. One of the most talked-about areas on the provider side is regenerative medicine. Regenerative medicine is the process of replacing or "regenerating" human cells, tissues or organs to restore or establish normal function. This is very relevant in the orthopedic space because of the possibilities created, including through the widening scope of minimally invasive treatments, and assisting the ability to heal from invasive surgeries. However, there are a lot of unproven technologies and treatments in this area, and we are already seeing heightened government interest, especially around claims related to treatments that are not supported by appropriate research. Both the 21st Century Cures Act⁵ and the U.S. Food and Drug Administration (FDA) published policy frameworks⁶ in this area, which suggests more focus in the years to come.

Regulatory Compliance Considerations

Investors who are considering partnering with orthopedic businesses should also understand the industry's unique regulatory issues, including but not limited to the following:

Practice Ownership

A majority of states prohibit non-licensed individuals from directly owning a medical practice or directly employing licensed professionals who will provide medical services. This prohibition is often referred to as the corporate practice of medicine and will apply to ownership by non-physicians in orthopedic practices. In states in which an investor desires to partner with an orthopedic practice, state law should be thoroughly researched and analyzed to determine how best to structure the transaction to comply with applicable state (and federal) laws—both in letter and spirit. Notwithstanding, there are several mechanisms by which non-physicians can participate in orthopedic businesses in states that do prohibit investors from directly owning in an orthopedic practice. For example, non-physician investors often form an administrative services company, owned by non-licensed individuals, that contracts with the professional orthopedic practice to provide the non-clinical support services to the business, with the physician owners and practice retaining full responsibility for the practice of medicine. With that said, there are numerous nuanced legal considerations involved in structuring this model that should be carefully considered

⁵ See, e.g., Sec. 3034-3036, 21st Century Cures Act, Pub. L. 114-255 (2016).

⁶ FDA announces comprehensive regenerative medicine policy framework (Nov. 16, 2017), available at <https://www.fda.gov/news-events/press-announcements/fda-announces-comprehensive-regenerative-medicine-policy-framework>.

during the transaction and, just as critically, subsequent operation of the business following a transaction's closing.

Ancillary Services

As mentioned earlier, orthopedic physicians refer their patients for a wide range of ancillary services. Ancillary businesses can be lucrative, but they often pose risk under federal and state fraud and abuse laws. It is important to understand how owners in an orthopedic practice are compensated from such ancillary businesses and how these ancillary businesses fit within the larger organizational structure of the practice to ensure compliance with healthcare laws. It is also important to understand how ancillary businesses are governed, especially where such businesses are not 100% under common ownership with a practice. For example, if practice physicians directly own in an independent ASC, there could be stringent non-compete restrictions that impact the practice and/or the platform from developing additional ASCs. Alternatively, practices without such services in-house may pose as an opportunity for growth and expansion.

Ambulatory Surgery Centers and Physician-Owned Distributorships

Many orthopedic surgeons have made significant investments in ASCs and in manufactured device distributorships, such as those providing spinal implants. As with respect to ancillary services, described above, these relationships can implicate healthcare fraud and abuse laws. While ASCs can meet a safe harbor to the federal anti-kickback statute, ownership and buy-ins can run afoul of such laws. Distributorship relationships are generally higher risk, and regulators often view them in a disfavorable manner. The federal government has long been concerned with physician-owned distributorships (PODs)⁷ in which physicians invest in a small manufacturer or distributor that only serves the owning physician's practice or facility. The government worries that this arrangement creates an improper incentive related to the surgeon's supply choices and utilization and could drive medically unnecessary care. With that said, some PODS are structured better than others, and careful diligence should be conducted to assess the magnitude of the risk.

Hospital Relationships

Investors are likely to favor orthopedic practices that have established long-lasting relationships with local healthcare systems and hospitals. Such relationships often take shape through various arrangements, such as transfer agreements, personal services agreements, and co-management agreements (discussed further below). These partnerships with a local health system can bolster business, but can also implicate federal and state fraud and abuse laws if not properly structured.

Clinical Co-Management

Co-management arrangements between orthopedic practices and healthcare systems are growing in popularity, but can also pose regulatory issues if not properly structured. Generally speaking, in co-management arrangements, a physician will oversee and manage a particular service line (e.g., orthopedics) within the hospital system to ensure it continues to provide effective, high-quality care. While these arrangements aim to increase integration and bolster quality, these

⁷ See Dep't Health & Human Svcs., Off. Inspector Gen'l, *Special Fraud Alert: Physician-Owned Entities* (Mar. 26, 2013), https://oig.hhs.gov/fraud/docs/alertsandbulletins/2013/POD_Special_Fraud_Alert.pdf.

arrangements can pose risk under federal and state kickback and self-referral laws if they are intended to induce or reward orthopedic referrals to the hospital.

Billing and Coding

As with all physician practices, billing and coding compliance is an important area to carefully diligence. Nuanced orthopedic-specific billing and coding practices, such as improperly billing ancillary services (e.g., durable medical equipment or physical therapy) without adequate documentation, improper use of incident-to billing for midlevel providers, and documenting medical necessity with regard to joint replacement procedures, should be carefully reviewed because errors can create legal risk and artificially inflate a practice's value. Accordingly, investors should strongly consider conducting an external billing and coding audit as part of transaction diligence.

Physician Compensation

Physician compensation and the share of ancillary revenue each physician receives must comply with healthcare laws, and, thus, historic compensation methodologies should be carefully scrutinized to confirm historic compliance with such laws. Further, orthopedic compensation models generally follow the “eat-what-you-kill” model, and the introduction of RVU-compensation models have often been met with resistance. Accordingly, in addition to regulatory considerations, it is important to strategically navigate transition compensation models toward structures that are, in addition to being compliant, effective in creating revenue growth and feasible to implement in strengthening orthopedic groups.

Partnership opportunities in this highly fragmented industry remain ripe and, as such, are expected to balloon in coming years. Notwithstanding, as with any healthcare partnership, investors should closely analyze the unique aspects of this sector and each target's compliance profile prior to making an investment.