

BUYING AND SELLING A PHARMACY



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INTRODUCTION

Without question, significant changes to the pharmacy profession are on the horizon. Third party payor cost-cutting moves, the anticipation of health care reform legislation, and increased fraud enforcement have all had a significant impact on the operation and profitability of pharmacies. This period of turmoil is both an opportunity for large pharmacies looking to acquire competitors, and a chance for small pharmacies and other market players to search for an "exit strategy." A goal of many entrepreneurs is to establish a startup company, grow it until it is an attractive acquisition target and then sell it and serve as an employee or consultant for the purchasing company.

From a purchaser's standpoint, acquiring a pharmacy has challenges that are not normally associated with non-health care industries. For example:

- Being dependent on third-party payers for revenue can be a mixed blessing. Third-party payers can, pursuant to a post-payment audit, recover revenue they have previously paid. As a result, from a purchaser's standpoint, financial statements (balance sheet and profit/loss statement) that initially look attractive might end up becoming less attractive.
- From a payer's standpoint, the ability of a pharmacy to successfully collect and retain revenue is dependent on the pharmacy's documentation. If the documentation is sloppy or non-compliant with reimbursement rules, then even though products may have been provided, the pharmacy will not be able to collect, or retain, its revenue. Likewise, non-compliant documentation can lead to an unfavorable post-payment audit.
- If a pharmacy has engaged in past fraudulent practices (e.g., payment of kickbacks or billing fraud), then it can be liable to the government for a great deal of money.

When acquiring a pharmacy through a stock purchase, the acquired pharmacy carries with it the liabilities that arose prior to the purchase. When acquiring a pharmacy through an asset purchase, the purchasing entity is usually not liable for prior acts of the selling entity. However, in an asset acquisition if the government concludes that the asset sale is, in reality, a "de facto merger,"¹ then the government might attempt to impose liability on the purchasing entity for the past activity of the selling entity. Although defenses can be raised to counter such an aggressive action by the government, the time and expense in defending the government's claim can be great.

¹ The following factors point to a "de facto merger:" the purchaser buys all of the seller's assets; the purchaser employs the seller's employees; the purchaser takes over the seller's premises; and the purchaser uses the seller's name.

WHAT A PURCHASER LOOKS FOR IN ACQUIRING A PHARMACY

In order to determine the potential risks involved in an acquisition, the purchaser needs to conduct a thorough due diligence review that incorporates the following:

- Product Mix. How much of the business is related to over-the-counter products...or compounded prescriptions...or narcotics...or commercially-available prescriptions...or durable medical equipment (“DME”)? A purchaser is most interested in recurring revenue. Is the pharmacy spread too thin by trying to provide everything to everyone?
- Provider and Supplier Number Issues. How many physical locations does the pharmacy have? Does the pharmacy have a DMEPOS supplier number and-or a Medicare provider number for each location? What are the pharmacy’s provider and supplier numbers? Has the pharmacy closed any locations in the past five years? Does any location have the appropriate pharmacy licensure?
- Payer Mix. The attractiveness of the payor mix is generally purchaser specific.
- Medicaid Issues. Is the pharmacy a qualified provider to one or more state Medicaid programs? What are the Medicaid provider numbers?
- Employment and Independent Contractor Issues. Does the pharmacy utilize independent contractors, part-time employees, marketing representatives and/or medical directors? Does the pharmacy have any employment or personal services contracts with any other health care providers? Do these arrangements comply with applicable safe harbors and Stark?
- Referral Source Issues. Does the pharmacy have any written or verbal relationship with health care referral sources such as physicians, hospitals, home health agencies or respiratory therapists? Do these arrangements comply with applicable safe harbors and Stark? Do the referral sources also refer to the purchaser? If so, their value to the purchaser will be diminished. Is the seller dependent on one referral source? If so, then the value of the seller will be diminished because of the impact on the seller if the referral source ceases to support the seller. As a general rule of thumb, a single referral source should not be responsible for more than 10% of the pharmacy’s business.
- Documentation Issues. Does the pharmacy have appropriate prescriptions in the patients’ files? How does the pharmacy obtain prescriptions? What audit procedures have been performed to verify proper documentation?
- Licensure and Sanction Issues. Have any licenses, permits, registrations or certificates of authority to operate any part of the pharmacy ever been revoked, suspended, investigated, or voluntarily surrendered after receiving notice of such investigation by any federal, state or local governmental entity or private accrediting agency? Is the pharmacy operating with all necessary licenses, permits, registrations and certificates of authority? Have any current licenses, permits,

registrations or certificates of authority been issued on a temporary or less than full status basis? What licenses, permits, registrations and certificates of authority have been issued and are currently in effect for the pharmacy (e.g., pharmacy license, pharmacist-in-charge license, DEA license, business license, occupational and sales tax license, oxygen distributor's license, and DME license)?

- Litigation, Audits and Reviews. Is the pharmacy aware of potential or ongoing litigation, audit, review or dispute with any payer, health care provider, governmental agency or private accrediting agency, which if successful, would have an adverse effect on the pharmacy?
- Legal. Has any shareholder, owner, officer, director, manager or employee of the pharmacy ever been (i) convicted of a health care related felony or been excluded from the Medicare or Medicaid program, or (ii) a party to a lawsuit involving the provision of health care services or payment for these services?
- Financial. A purchaser will carefully examine a seller's financial statements and related documents, including a sample of expense reports and canceled checks. Purchasers are normally interested in asset acquisitions. Hence, the assets sold to the purchaser will be free and clear of encumbrances, and seller liabilities (e.g. accounts payable and employment liabilities) should remain with the seller. If a seller has substantial liabilities, it is difficult to establish a purchase price because there may not be much of the purchase price to distribute once the liabilities are paid. How is the pharmacy performing once all expenses are taken into account? Are the earnings margins in line with industry norms? Are they lower than industry norms and, if so, why? Does the seller have too many locations with too few patients? Does the seller have too many employees for the size of the pharmacy? A purchaser expects the business to be profitable from the date of the acquisition. If the pharmacy's bottom line is low and this is due to factors and expenses the purchaser can immediately eliminate, then the current earnings margins should not necessarily impact the sale. However, if earnings are low due to factors outside of the purchaser's control, such as too many locations with too few patients, there is little a purchaser can do to remedy the situation. In that situation, the seller's options are either to grow the business in the low producing locations or to downsize and concentrate on the strong locations. Is the business generating enough cash flow after all expenses are paid? Does the pharmacy have sufficient cash to purchase new capital equipment as necessary?
- Understanding Day-to-Day Operations. If the purchaser is expending the resources to conduct due diligence, then it is a safe assumption the purchaser finds the seller attractive and desires to incorporate it into its own operation. Therefore, the purchaser's due diligence team must learn how the business is run, and specifically, the steps the seller has taken to make the business a success. The purchaser will study the entire process from intake to billing to customer service. The purchaser will meet with employees; they are the best people to answer questions regarding the day-to-day operations of the business. The seller will normally not be a part of the interview process. The purchaser may request to participate on a few delivery or service calls.

Normally, when acquiring a provider, the purchaser pays a substantial amount of money. As a result, the purchaser should verify that it is not inheriting any surprises.

HOW A PHARMACY CAN MAKE ITSELF ATTRACTIVE TO A PURCHASER

Millions of homes are sold every year. Before the realtor brings the first prospective purchaser to look at the home, and before the first open house is held, the homeowner normally expends money and effort to make the home as attractive as possible.

This same concept holds true when the owner of a pharmacy wishes to sell it. The owner desires to obtain the optimal price for the pharmacy. Just like a homeowner needs to prepare his home for sale, the pharmacy needs to take several preparatory steps before seeking purchasers. These steps can be summarized as follows:

- Financial Statements. The pharmacy should have an outside CPA prepare a current balance sheet (statement of assets and liabilities) and a year-to-date profit and loss statement (statement of income and expenses).
- Income Tax Returns. The pharmacy should have copies of federal and state tax returns for the last three calendar or fiscal years.
- Billing Audit. The pharmacy should contract with an outside billing consultant for an on-site visit to conduct a mock audit of the pharmacy's documentation and billing procedures. A valid concern of a purchaser is whether the pharmacy's documentation (i.e., patient files) and billing procedures can withstand a third party payor audit and whether they are sufficient to allow the purchaser to safely continue billing after the sale takes place. If the purchaser has concerns about the pharmacy's documentation and billing procedures, then the purchaser may reduce its offering price in order to compensate for the concerns, delay the purchase, or refuse to close on the sale altogether. By having a mock audit performed, the pharmacy can clear up many of the purchaser's anticipated concerns in advance. If problems are discovered during the mock audit, then the pharmacy can address and resolve these problems before engaging in negotiations with the purchaser.
- Medicare Supplier Numbers. If the pharmacy provides DME, it needs to verify that it has an active Medicare supplier number for each of its locations.
- Medicaid Provider Numbers. If the pharmacy is a qualified provider to one or more state Medicaid programs, then it needs to verify that it has the requisite active Medicaid provider numbers.
- Employees and Independent Contractors. The pharmacy needs to examine its relationship with each individual who is involved in marketing on behalf of the pharmacy ("marketing rep"). If the pharmacy designates a marketing rep as an employee, then the pharmacy must assure itself that the marketing rep will be classified by the IRS as a bona fide employee. This allows the pharmacy to take advantage of the Employee Safe Harbor under the Medicare anti-kickback statute and to pay the employee on a production basis. The Department of Justice ("DOJ") and

Office of Inspector General (“OIG”) are sensitive to sham employment arrangements. A pharmacy should avoid the use of independent contractor marketing reps, if possible. If the pharmacy nonetheless chooses to utilize independent contractor marketing reps, the pharmacy must comply (or substantially comply) with the Personal Services and Management Contracts Safe Harbor. Among other requirements, the compensation to the marketing rep must be fixed one year in advance and must be the fair market value equivalent of the rep's services.

- Referral Sources. The pharmacy needs to verify that it is not paying any remuneration to any referral source in exchange for referrals and/or arranging for referrals. Additionally, the pharmacy needs to be able to assure the purchaser that the referral sources are loyal to the pharmacy because of the excellent service the pharmacy has given over the years to its customers; that the referral sources’ loyalty is not limited to the individual owner of the pharmacy; and that, in all likelihood, the referral sources will continue to refer to the pharmacy once it is sold to the purchaser.
- Documentation. The pharmacy needs to verify that it has the appropriate documentation, especially prescriptions, in the patients’ files. The pharmacy needs to verify that it has properly executed Assignment of Benefits forms in the patients’ files. These tasks can be accomplished during a mock billing audit.
- Licenses and Permits. The pharmacy needs to verify that it has all requisite licenses, permits, registrations, and certificates of authority to conduct its business. These include pharmacy licenses, pharmacist-in-charge licenses, business licenses, occupational licenses, sales tax licenses, oxygen distributor licenses and DME licenses, issued by federal, state, county and/or city governmental entities.
- Audits, Reviews and Investigations. Preferably, before negotiating with a purchaser, the pharmacy needs to resolve any ongoing audit, review or investigation by a PBM, CMS, DOJ, OIG, IRS, or any other agency or entity. If such an audit, review or investigation cannot be successfully resolved prior to entering into negotiations with a purchaser, then the pharmacy needs to fully explain the audit, review or investigation to the purchaser and predict the outcome, including an estimate of the potential overpayment or settlement payment.
- Litigation. Preferably, before negotiating with a purchaser, the pharmacy needs to make a concerted effort to resolve any ongoing litigation. If the pharmacy is unable to do so, then it needs to be able to fully explain the details of the litigation to the purchaser.
- Customer Satisfaction. The pharmacy needs to verify that its customers are satisfied with the services they receive from the pharmacy. The purchaser will want to avoid the situation where, after closing, it discovers that a number of the pharmacy’s customers are dissatisfied with the service provided by the pharmacy. A dissatisfied customer might register a complaint with a governmental agency or with a third party payer, which could trigger a review, audit or investigation. Likewise, if the pharmacy provides products to members of a managed care organization, a significant piece of business could be lost if the managed care organization cancels its contract.

Often, the purchaser will attempt to reduce the purchase price if the purchaser concludes there are uncertainties that might affect the value of the acquired pharmacy subsequent to closing. By addressing these issues prior to entering into negotiations with the purchaser, the pharmacy will be in the position to insist on the best purchase price possible.

STOCK VERSUS ASSET ACQUISITION

When acquiring a pharmacy, the purchaser can either purchase the assets of the business or the stock of the owner of the pharmacy. Each type of purchase results its own unique set of benefits and drawbacks.

In an asset acquisition, as a general rule, the purchaser does not assume any liabilities of the seller except for the liabilities that the purchaser expressly agrees to assume. Most importantly, if the seller has engaged in prior fraudulent activities, then generally speaking, the government will not attempt to impose successor liability on the purchaser.

As a caveat, if the government concludes that the asset sale is, in reality, a "de facto merger," then it might attempt to impose successor liability on the purchaser. See Footnote 1 for the factors that point to a "de facto merger."

Medicare Part B supplier numbers are tied to tax identification numbers. In an asset acquisition of a pharmacy that has a DME operation, the acquired DME operation will be continued under a new tax ID number (the purchaser's tax ID number). If the purchaser moves the acquired DME operation to an existing DME location owned by the purchaser (for which the purchaser already has a supplier number), then there will be no requirement for the purchaser to apply for a new supplier number. However, as is often the case, if the acquired DME operation will be continued at the seller's old location, or at a different location, then the purchaser will need to apply for a new supplier number for that location. Before submitting an application for a new supplier number, the DME company must be accredited. In addition, the DME company must have a surety bond for each location that has a supplier number issued to it. It normally takes four to eight weeks to obtain a new supplier number from the National Supplier Clearinghouse ("NSC"). Normally, during the interim period, the purchaser can sell products and services out of the new location, can accrue the claims to be submitted at a later date, but cannot actually bill for the claims until the new supplier number is received. In short, the purchaser will experience a cash flow crunch. Unfortunately, the purchaser cannot bill for the products and services under the seller's old supplier number (because the seller is no longer conducting the DME operation) and the purchaser cannot bill under one of the purchaser's supplier numbers attached to a different location.

On the other hand, in a stock acquisition, the pharmacy and/or DME operation remains with the same corporation (the entity whose stock is sold) and the supplier number remains attached to the same tax ID number (the corporation whose stock is sold to the purchaser). Therefore, there is no break in billing and the purchaser does not experience a cash flow interruption. The downside is that if the selling corporation engaged in prior activities that result in an overpayment or a recoupment demand or in an allegation of fraud, then the selling corporation remains liable for the prior activities.

STEPS TO BRING AN ACQUISITION TO FRUITION

The purchaser and seller should take the following steps that will increase the chances that the acquisition will be consummated:

- The purchaser and seller should each employ an experienced transactional attorney and an experienced health care regulatory attorney.
- The purchaser and seller will initially execute a confidentiality/non-disclosure agreement. This will allow the seller to forward financial and other confidential data to the purchaser so that the purchaser can make a preliminary determination as to whether it wishes to follow through with the acquisition. Once the purchaser decides that it wishes to follow through with the acquisition, then the parties will sign a non-binding letter of intent. The letter of intent needs to be as detailed as possible and contain as many of the actual terms as possible that the parties believe will be included in the definitive agreement (either a Stock Purchase Agreement or Asset Purchase Agreement). The letter of intent may set out the date the definitive agreement will be executed and the date that closing will occur. When executing the letter of intent, the purchaser and the seller will have decided whether the acquisition is an asset acquisition or a stock acquisition.
- Between the time of execution of the letter of intent and the time of execution of the definitive agreement, the purchaser will conduct due diligence. In reviewing files, the purchaser will ascertain if the files contain the necessary documentation to submit claims and, equally as important, to ascertain if the files contain documents to support medical necessity in the event of a post payment audit.
- The seller and purchaser will then execute the definitive agreement. In so doing, the purchaser will desire to pay as little cash up front as possible and to pay as much of the purchase price on the back end as possible. Payment of the balance of the purchase price will be conditioned on the veracity of the seller's representations, and that no third party audits and/or government inquiries or investigations arise that will jeopardize the value of the acquired business. If problems do arise following closing, then the definitive agreement will give the purchaser the right to offset a portion of the purchase price (to be paid on the back end) against the damages to be sustained by the purchaser as a result of the unanticipated problems following closing. In short, the purchaser will retain as much of the purchase price as possible to pay for unanticipated problems that arise following closing. To use the time-honored phrase: "Possession is 9/10ths of everything." On the other hand, the seller will desire to be paid as much cash up front as possible and to receive as little of the purchase price on the back end as possible.
- At closing, the parties will execute the appropriate instruments necessary to transfer assets or assign stock, assign leases or sublet premises, assign contracts and other documents necessary to transfer the business. Also, prior to closing, the purchaser will ascertain which employees of the seller that the purchaser wishes to retain. A condition of closing should be that the designated employees sign employment agreements with the purchaser that include reasonable non-compete and non-

disclosure provisions.

- In a stock acquisition, the purchaser will wait as long as possible before the acquired corporation is collapsed or merged into the purchaser's corporation. Likewise, as much time as possible may lapse before the operations of the acquired corporation are merged or collapsed into the purchaser's operations. In this way, if unanticipated problems arise with reference to the acquired corporation's past actions, then the purchaser can assert the argument that any type of successor liability should remain with the acquired corporation and should not be imposed on the purchaser.

As a condition of closing, the purchaser may require that the principals of the seller remain as employees of the purchaser for a period of time (e.g., six to twelve months). As a condition of their employment, the principals of the seller will introduce the purchaser and the purchaser's management and employees to key referral sources. Of course, principals of the seller will have to execute reasonable non-compete/non-disclosure agreements.

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