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.

<u>What a Purchaser Looks for in Acquiring a Pharmacy</u>

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:

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[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.

- 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.