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Investing in Dental Practice Management: Key Issues and Notable Transactions

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Investing in Dental Practice Management: Key Issues and Notable Transactions

The dental practice management (“DPM”) model has become an increasingly popular investment vehicle with management companies and private equity firms. The DPM model provides an opportunity for a management company to form a joint venture or other business arrangement with one or more dental practices. The management company performs the administrative and management services for the dental practices, allowing the dentists to focus on patient care. In return, the management company receives a fee for its services and/or the opportunity to share in the revenue or profits of the practices it manages. Many private equity firms see dental practice management companies as a stable investment, which is evidenced by the number of DPM deals closed in recent months. The DPM structure provides certain economies of scale to the practice that were not otherwise achievable. While the DPM model grows in popularity, so does regulation and scrutiny around the industry. A core overriding regulatory issue revolves around the extent of control of the practice and the extent of profit or revenue sharing a non-dentist investor can have. Management companies and investors need to be aware of the unique issues that often arise in DPM transactions.

This article summarizes recent developments in the DPM industry, including recent notable transactions and the governmental investigations underway in the industry. In addition, this article uses certain states as examples to illustrate the regulations applicable to the DPM structure in those states. Finally, this article will address the key legal and business issues that all dental practice management companies and their investors need to keep on their radars when considering a DPM transaction.

I. REPRESENTATIVE TRANSACTIONS.

The DPM structure has become such a popular investment vehicle that many large deals have recently been completed with the help of a private equity firm or management company backing the deal. Below is a summary of some of the largest, most recent deals in the DPM industry. Financial information pertaining to the deal is provided when available.

- August 8, 2012 – Private equity firm H.I.G. Capital LLC acquired InterDent, Inc., a provider of DPM and licensing services. The acquisition is intended to allow InterDent to expand its business operations and offer dental care services to multi-specialty dental practices.
- March 28, 2012 – Following OMERS’s acquisition of Great Expressions Dental (see below), Great Expressions acquired Exceldent, LLC, another dental practice management company. The acquisition allows Great Expressions Dental to expand its footprint in the Northeast region and brings the total number of Great Expressions Dental offices to 170. Great Expressions Dental now covers nine different states.
- May 14, 2012 – Topspin Partners LBO and AUA Private Equity Partners, LLC, private equity firms, made an investment in Brighter Dental Care, a DPM company.

- February 9, 2012 – Private equity firm JLL Partners acquired through its affiliate American Dental Partners, Inc., a multi-disciplinary dental company, for a purchase price of \$398 million, including \$81 million in assumed debt. JLL Partners acquired all of the outstanding shares of American Dental for \$19 per share in cash, a premium of 83 percent to the closing price of the shares just a few months before purchase. The deal took American Dental off the NASDAQ.
- October 24, 2011 – Private equity firm Audax Group sold Great Expressions Dental Centers, Inc. to OMERS Private Equity, an investment arm of the Ontario-based pension fund. OMERS purchased the string of dental centers in seven U.S. states through a management-led buyout.

II. State Regulation.

Many state laws and regulations directly address the DPM model. Following is a sample of how two states deal with the corporate practice of dentistry and the use of management companies:

North Carolina:

North Carolina is a particularly difficult state for DPM companies and private equity firms to invest in or do business with dental practices. In July 2012, North Carolina passed a law that created a six-member task force made up of members of the State Board of Dental Examiners (the “Board”) and the North Carolina Society of Dentists, a licensed dentist, a management company representative, a legal professional representative and a small business representative. The task force is charged with making recommendations to the Board with respect to the rules to be adopted by the Board to govern dental management agreements.

The current Board rules remain in effect until the Board decides to adopt new rules proposed by the task force. Currently, all management agreements must be reviewed by the Board. Among other things, management companies cannot have any control over any aspects of the business that are related to the practice of dentistry and the management fee cannot be tied to profitability or revenues of the practice. As such, flat management fees or cost-plus fees are typical in North Carolina.

Private equity firms and management companies cannot directly invest in North Carolina dental practices since North Carolina law (like the law of many states) does not permit any non-licensed dentist or business corporation (or other non-professional entity) to directly or indirectly own a North Carolina dental practice. However, North Carolina law would not restrict a private equity firm or management company from owning any interest in a management company that performs services for the dental practice in accordance with North Carolina law.

Florida:

Florida law provides that only licensed dentists can participate in certain activities related to the clinical operation of a dental practice, including employing dentists or dental hygienists, controlling the use of any dental equipment or material and directing or controlling a dentist's clinical judgment. In addition, dentists are not permitted to enter into a relationship with a non-dentist pursuant to which such unlicensed individual or entity exercises control over certain clinical activities, including course of treatment, patient records, pricing, credit, refunds, warranties, advertising, office personnel and hours of practice.

Florida law expressly provides that a licensed dentist may enter into an agreement with a non-dentist to receive "Practice Management Services," which include services related to (a) suitability of office space, furnishings and equipment; (b) staff; (c) regulatory compliance; (d) methods to increase productivity; (e) inventory and supplies; (f) information systems; (g) marketing plans or advertising; (h) site selection, relocation, design or physical layout; and (i) financial services and other back-office services. Under Florida law, however, practice management agreements may not allow a non-dentist to be involved in certain aspects of the practice, including (a) any actions that preclude or restrict the dentist's ability to exercise independent professional judgment over all aspects of the delivery of dental care; (b) any aspect of the employment or retention of clinical personnel; (c) any actions that limit or define the scope of services offered by the practice; (d) any actions that limit the methods of payment accepted by the practice; or (e) any actions that require the use of patient scheduling systems, marketing plans, promotion or advertising, which in the judgment of the dentist will have the effect of discouraging new patients or current patients from seeing the dentist.

Finally, licensed dentists may not agree to a covenant not to compete with a non-dentist or entity that is not licensed to practice dentistry.

III. Government Investigations.

There are currently several state investigations and a federal investigation led by Senator Charles Grassley into the DPM industry and structure. The investigations focus on whether the structure is resulting in Medicare and Medicaid fraud and other abuses.

Federal Investigation:

Senator Grassley is investigating several Medicaid-funded dental clinics that treat Medicaid children. His investigation is focused on the ownership structures of these dental clinics, the incentives offered to dentists through the management structure and the clinics' participation in Medicaid. Senator Grassley alleges that the business model of these dental clinics pressures dentists into performing unnecessary high-reimbursement services on children using Medicaid (e.g., using stainless-steel crowns to treat cavities where a filling may be more appropriate). Grassley claims that while dentists technically own the

practices, the management companies that provide the administrative services are effectively controlling clinical operations in violation of state law. The primary reason for such alleged abuses, according to Senator Grassley, is that the management fee structure incentivizes dentists to perform expensive and often unnecessary procedures.

State Investigations:

The state of Texas is currently conducting investigations into dental practices on several fronts, including (a) an investigation by the Texas Office of the Inspector General into alleged Medicaid fraud by a company that processes authorization forms for Medicaid procedures; (b) an investigation by the state's attorney general into alleged Medicaid fraud and overbilling by dental chains and orthodontists; and (c) parallel investigations by the Texas Health and Human Services department and the Texas State Board of Dental Examiners.

Connecticut is currently investigating alleged Medicaid fraud by Kool Smiles, a multi-state dental chain, for allegedly billing Medicaid for unnecessary procedures performed on children. In addition, in May of 2012, the FBI arrested two individuals in Connecticut, one of whom was a licensed dentist, for allegedly engaging in a Medicaid fraud conspiracy in the amount of \$20,000,000.

IV. Key Business and Legal Considerations.

The following are a few of the key business and legal issues relating to the DPM business.

1. **Structure.** DPM companies and private equity firms desiring to invest in management companies need to engage experienced legal advisers early in the process in order to ensure that the structure of the transaction fits within the parameters of the regulatory framework and applicable state corporate practice of dentistry doctrine. Investors need to determine early on at what level of the structure they are permitted to invest (i.e., management company level or practice level), based on the applicable state regulations. For example, North Carolina and Florida (along with other states) will not allow a non-dentist to own or control the practice entity, but neither state has restrictions on owners at the management company level.
2. **Due Diligence.** Concurrently with analyzing the structure of the transaction, the investor or management company should closely analyze the practice or company with which it is entering into the transaction to ensure that the seller has been operating in accordance with applicable law and all healthcare regulations. Here, it will want to assess if there are any significant liabilities that would be assumed by the management company or investor as a result of the transaction or that would remain with the company or business practices that need to be changed. Specific issues that will be focused on include proper consent for a minor's surgery, Medicaid billing, medical necessity, unneeded surgery, proper licensure and Medicaid filings, compliance with corporate practice concepts, reliance on key

dentists, non-compete enforceability, labor litigation, policies on legal compliance and more.

3. Fee Structure. While a fee based on a percentage of revenues or profits may be the most desirable option to management companies and private equity firms, it may not be permissible in certain states (i.e., North Carolina). In many states, it is not as clear, and the parties, along with their advisers, need to determine the amount of risk they willing to take in connection with the fee structure adopted for management services.
4. Restrictive Covenants. Certain states, like Florida, may restrict dentists from entering into covenants not to compete with unlicensed individuals or entities, such as a management company. The buyer and its legal advisers should ensure that the restrictive covenants proposed are permitted under applicable state law and, if not, carefully consider whether the management company or private equity firm is willing to accept the risk that the key dentists would not be restricted from competing with the practice or management company.
5. Governmental Filings and Interaction. In order to manage expectations regarding timing of the closing of the transactions, the parties need to determine early on whether, in addition to the governmental filings and notices required of any healthcare transaction, any additional filings, notices or interactions are required for a DPM transaction in the particular state and the impact these will have on closing. For example, in North Carolina, the parties may have to wait weeks (or even months) for the Board to review and approve the management agreement.
6. Control. Most states restrict to some extent the involvement of the management company in the practice's operations. Before embarking on a DPM transaction, the management company (or private equity firm) should be sure it is comfortable with the amount of control it will be permitted to have over the practice and whether that level of control fits within its business model.
7. Controlling Dentist Issues. Often, DPM transactions are structured so that a "friendly" dentist is the sole owner of the practice entity. This dentist will enter into a nominee agreement with the management company entity, restricting the dentist's ability to vote his or her shares or membership interests and ability to freely transfer his or her ownership interest in the practice entity. The nominee agreement typically requires the dentist to consult with the management company (or be subject to mandatory redemption) on significant issues impacting the practice. These provisions can raise concerns with the corporate practice of dentistry in many states. These nominee agreements need to be closely analyzed to determine whether they grant too much control to the management company entity in violation of state law. Also, in order to protect its investment, the investor or management company needs to ensure that the "friendly" dentist is subject to enforceable covenants not to compete. While the non-dentist entity cannot be given so much control over the dental practice that the arrangement violates the corporate practice of dentistry, too much control in the dentist poses a business risk to the investor or

management company. If the dentist is too heavily relied upon, losing the dentist could have a significant impact on the business and practice.