

Critical Steps Before Developing an Ambulatory Surgery Center

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The freestanding ambulatory surgery industry has seen tremendous growth since the first dedicated freestanding outpatient center was founded in Phoenix in 1970. Today it is estimated that over 2,400 surgery centers are in operation throughout the United States. The health care industry is also experiencing growth and rapid changes effecting the delivery of care. Change in reimbursement in health care is effecting all providers which, in turn, requires ambulatory surgery centers to operate more efficiently than ever before.

This article submits that with careful and competent planning prior to actual development and construction, the risks inherent in developing a de-novo facility can be substantially minimized, greater efficiencies can be achieved and the goals of the principals developing the facility can be met and exceeded.

Background In the course of our practice, we see common mistakes made in the surgery center pre-development process which negatively effect the viability and purpose of an ambulatory surgery center throughout its life span. These mistakes are exceptionally difficult to undo once the center is in operation. However, regardless of whether it is a hospital or a physician, the mistakes can be easily avoided through thorough research and the engagement of competent professionals to assist the principals in meeting their goals.

Thus, the following are four critical steps which, performed and executed correctly prior to development, will augment the viability of an ambulatory surgery center project.

1. Development of a Comprehensive Business Plan We often use the analogy of building a house when meeting with new clients. Before you build, you need to take soil samples and construct a proper foundation. The development of a business plan is the first step toward the successful development of any business, including an ambulatory surgery center. Thus, the business plan serves as the foundation for the project.

The business plan should include both micro and macro factors which will give indication as to the viability and most successful manner to structure the venture. Some macro-economic and macro-operational issues include whether there is an overabundance of competing facilities (hospitals and surgery centers) in the market, the ability for the venture to gain and retain key third party payor contracts due to pre-existing relationships in the market, the history of the development of independent for profit ventures in the market, and historic reimbursement in the market. A synopsis of some

micro factors include meeting with physicians and gathering data regarding the number of cases and types of cases that will be performed at the facility, political factors singular to the market, the mix or type of cases expected to be performed at the facility, the desires of the physicians regarding the operation and day to day management of the facility, the practice patterns and supply cost patterns for the physicians, and the financial resources of the owners of the facility.

The business plan should include detailed financial data including a minimum of three (3) pro forma financial forecasts based on volume of cases performed. Included should be a projected income statement, sources and uses of funds, balance sheet, supply cost per case assumption, revenue per case assumption, staffing pattern assumption, expected payor mix as a percentage of volume, assumption regarding equipment requirements, and a debt to equity assumption. The data gathered (described above) should be used to make these assumptions. Furthermore, in concert with the architect and/or designer (see below) the developer should determine the size of the facility. A key concern is overbuilding based on over optimistic projection of cases. Similarly, in almost every instance, it is important to be able to expand the size and scope of the project based on changing needs.

The business plan should also set forth a legal and operational structure for the venture. After conferring with the client and their legal counsel (see below), a legal entity to operate the venture (limited liability company, limited partnership, limited liability partnership) should be selected which will meet the needs of the principals participating in the venture. Importantly, if the project will be joint ventured with physicians and/or a hospital, certain assumptions regarding ownership, governance, rights and duties of the owners, and overall operation of the surgery center should be set forth in the business plan. See Joint Ownership below. Lastly, if the project will be owned by more than one party, a capitalization structure must be set forth which prices the units of membership interest in correlation with the projected equity raised and debt incurred.

In summary, the development of the business plan has a threefold purpose. First, it is necessary to lay a firm foundation for the project so that the investors in the ambulatory center have a more complete understanding of the dynamics inherent to the venture's success. Second, the business plan should also be used to secure financing and other capital required for the project since nearly all surgery center development projects utilize debt financing. Third, regardless of whether the project is begun by a hospital or by a group of physicians, if the founding party desires to enter into a joint ownership arrangement, the business plan is used as a starting point to discuss joint ownership since it includes all material factors relating to the surgery center's development, operation and ongoing viability.

2. Joint Ownership If there is one factor which contributes the most to the long term success of an ambulatory surgery center, it is the successful consummation of joint ownership arrangements with strategic partners prior to the development of an ambulatory surgery center. While there are many, and will continue to be many successful surgery centers owned solely by hospitals and physicians, the changing dynamics of the health care industry lends itself to provider alignment. Historic pitfalls include:

- One physician owning too much of the surgery center which creates professional jealousy.
- A hospital owning too much of the surgery center which creates resentment by physicians because they feel that they lose control and direction over patient care which is a common reason for the establishment of a surgery center by physicians.
- Control vested in the hands of too few, or one entity. The need for a mutually beneficial arrangement is of critical importance.

There are numerous tax, legal and administrative issues which must be addressed during the course of negotiations. Key factors include the balance of powers, rights, duties, and obligations as well as the division of equity in the project. These issues can be successfully addressed with competent advisors with experience in surgery center joint ventures and principals willing to make the effort to correctly structure a venture to augment its long term viability. Furthermore, it is important for the participants to acknowledge the contribution of each potential partner so that the developer and the advisors to the project can structure a mutually beneficial joint ownership arrangement which meets the strategic goals of each partner.

Too often political and personal issues impede the actualization of a joint venture; however, if a surgery center project, through either the efforts of the developer, the principals, or their advisors, can avoid the common joint ownership pitfalls listed above and enlist the support of key strategic partners in the venture, it will greatly enhance the long term success of the project.

3. The Overbuilding Phenomena - Selecting an Experienced

Designer The development of an ambulatory surgery center involves a series of complex and interrelated tasks. A surgery center is a high "fixed cost" business with the three highest expenditures during development being construction costs, land acquisition costs, and equipment costs. None of these costs vary with volume or revenue generated by the surgery center; therefore, they are deemed to be fixed. In fact, there are only two material variable costs associated with operating a surgery center: supply cost and staffing. Thus, the economic viability of a surgery center is very volume sensitive since enough cases must be performed to meet the relatively high fixed costs. However, once the volume reaches the fixed cost level, or break

even point, the surgery center can experience significant economies of scale once the census exceeds the break even point. The most successful surgery centers take advantage of these economies of scale.

The key to realizing economies of scale, of course, is to build a quality facility to meet the anticipated volume, without overbuilding and adding unnecessary expense to the project. This will minimize the fixed cost and give the facility a greater chance to meet its financial and budgetary goals.

It cannot be emphasized enough that the selection of an architectural firm and/or design-build firm that has experience designing numerous ambulatory surgery centers in different states is of paramount importance since state and local regulations can vary and effect the size and scope of the project. It is strongly suggested that the participants in the surgery center venture interview firms with expertise designing and building numerous ambulatory surgery centers so that the architect and the developer work in conjunction with one another to minimize space requirements and still maintain a facility with the highest standards of care.

4. The Legal and Regulatory Hurdles - Selecting the Right

Attorney The health care industry is a highly regulated industry which requires expertise in tax, corporate/partnership, securities, and administrative law issues. Since many ambulatory surgery centers are owned by physicians and other partners (hospitals, management firms), the attorney selected must be familiar with the Stark laws, the Safe Harbor provisions, private inurement issues for not for profit hospitals, revenue rulings from the IRS, advisory opinions from the Office of Inspector General, and numerous state and federal laws governing for profit joint ventures.

There are many legal and regulatory roadblocks which must be navigated in order to consummate a successful surgery center project. It is imperative that the law firm selected has experience in all facets of health law, as well as specific experience assisting clients in the surgery center industry. Apart from the regulatory aspects, key tasks include assisting the developer in selecting an operating entity for the project, formation of the surgery center legal entity, drafting the operating agreement or limited partnership agreement, drafting the prospectus and related offering documents (if joint ventured), and working with state regulatory agencies during licensing.

The selection of a law firm that is familiar with the nuances of the laws and regulations specific to the surgery center industry and who is motivated to make the venture work for the client is invaluable to the developer and the client during and after the pre-development process.

Conclusion In conclusion, the four critical factors set forth above are interrelated and can be performed simultaneously. The numerous pitfalls inherent in the pre-development process can be overcome prior to the

commencement of any ambulatory project if careful planning is utilized to establish a foundation for the long term success of the venture.

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