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Operating Agreements for California Surgery Centers

In this article, I explain the basic negotiation points in an Operating Agreement for a California ambulatory surgery center (ASC). I focus mainly on control and on exit (buy-sell).

Control

Control starts with voting percentages, meaning, who has sufficient votes to control the surgery center's decision-making? If the ASC has a board, control means the number of votes on the board. Those with control like simplicity. If you already have control, you want to end the discussion there. An Operating Agreement drafted by the controlling member frequently has a short section on management that states the percentages or votes (i.e. control) and nothing else.

The physician / members without control want complexity, that is, they want provisions that restrict the controlling member. Minority, non-controlling owners need to protect themselves from majority action. Protection usually comes in the form of veto votes, which give the minority a right to stop a particular action proposed by the majority. Consider these veto rights:

Veto Right	Rationale
Hiring, firing, replacing the manager or officers	Although the minority won't run the operations of the surgery center, they want some control over who will.
Salaries & bonuses for management	Minority owners should prevent control persons from siphoning off substantial salaries and bonuses, leaving no profits for anyone else. This is doubly true as against management companies, which can be black holes for profits.
Affiliate transactions	This veto vote guards against the manager entering into sweetheart deals with its affiliates thereby redirecting profits to itself.
Distribution of profits	This veto vote helps minority physicians ensure some minimum distribution of profits to themselves.
Transfer of ownership interests	If the majority wants to sell their ownership to a third party, the minority might want to reject that third party as their new partner.
Issuing ownership interests to existing or new members	This veto vote guards against the unfair dilution of the minority physicians, including when the majority sells ownership to themselves or friends at sweetheart prices.

Selling the surgery center or merging	The minority wants some level of control over its ultimate exit, including to prevent the majority from selling the surgery center in a sweetheart deal that primarily benefits the majority.
Amendments to the Operating Agreement	The minority doesn't want the majority to unilaterally change the terms of the deal.

Exit, a.k.a. Buy-Sell

Every Operating Agreement should have provisions for the buy-back of ownership. I call this the economic divorce; others call it buy-sell. If the surgery center, for whatever reason, needs to remove a particular physician, the Operating Agreement gets you a divorce on terms that are fair to everyone.

Triggers for Buy-Back. Traditional buy-sell involves what I call the 5 D's & 2 B's. The 5 D's are disqualification of license, death, disability, divorce and dispute, and the 2 B's are bankruptcy and bad transfers. I talk about these buy-sell trigger events at length on my website.

Other buy-back triggers may include a litany of "for cause" events, and they essentially give the control persons a number of vague and open-ended reasons to remove a physician. Some ASCs just cut to the chase, without need for pretext, and permit the control group, at-will without-cause, to buyback a physician's ownership. This latter expulsion can be important to the continued, smooth operations of the surgery center, but it's clearly dangerous to the minority physicians who are subject to removal.

Surgery centers frequently have buyback provisions to remove individual physician / investors based on their insufficient use of the facilities. Physicians who regularly use the surgery center's facilities can become unhappy with a physician who does not. They see the non-using physician as a parasite who takes his distributions from the surgery center but who does not contribute.

The legal basis (pretext?) for the buyback comes via the federal Anti-Kickback statute, which gives a safe harbor for ambulatory surgery centers. One requirement of the Kickback safe harbor is that each physician-owner must perform at least 1/3 of his Medicare-covered ASC procedures in the surgery center. The surgery center's Operating Agreement can take advantage of the safe harbor to permit buy-back of the ownership of a physician who does not use the facilities. On its face, the buy-back seems justified because it only ensures ongoing compliance with the safe harbor.

Buy-Back Price. The buy-back price is the crucial term for all buy-sell events. A high buy-out price gives the exiting physician a windfall. A low buy-out price is unfair and leads to litigation. The trick is finding a procedure that ensures a fair price – for example, using a neutral appraisal process or accounting formula to fix a price. Next look at payment terms, because payment up-front in one lump sum is much better than payment by promissory note over a long period of time.

Non-Competition Covenant. In California, it's legal to apply a non-competition covenant to a minority physician who has been bought out. Most non-competition clauses are for a period from 1 to 3 years, within a 10 mile radius. I have lots of articles on this topic on my website. ******Call me if you want to talk more.

Simpsons

- *Marge*: This is the worst thing you've ever done. *Homer*: You say that so often that it's lost all meaning.
- *Bart to Homer*: It's just hard not to listen to TV: it's spent so much more time raising us than you have.
- *Homer*: I hope I didn't brain my damage.