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Understanding and evaluating deal considerations in the behavioral health investing sector

An update for private equity investors

This issue explores certain operational, financial, and tax due diligence, as well as structuring issues that private equity investors should consider when making investments in behavioral health companies.

Financial accounting

Revenue cycle—Like many providers, behavioral health entities have an extremely complex revenue cycle process that includes billing and collecting from multiple payers (including Medicare and Medicaid). Due to the inherent risks associated with the revenue cycle, a large percentage of providers struggle to correctly account for revenue and accounts receivable. This can impact the historical quality of earnings and quality of accounts receivable. Broad diligence should be performed by health care trained professionals to understand the Target's revenue cycle process and impact on financial statements.

Health care reform impact—Many states are struggling to control Medicaid health care costs. In addition, Medicare rates are at risk for future reductions by the federal government. Potential cuts to reimbursement rates could negatively impact financial results. To offset these cuts, more patients are expected to be qualified for Medicaid coverage. These on-going changes to payer mix and reimbursement levels should be considered when assessing a target.

Reimbursement trends—As more people gain insurance coverage under the Affordable Care Act, states are modifying their disproportionate share (DSH) payments. Behavioral Health (specifically psych) providers can be dependent on this supplemental funding source. Understanding the potential changes to a state's reimbursement program is critical, as they can significantly change how a buyer may evaluate a target's business.

Tax structuring and diligence

Tax structuring considerations—Certain states require behavioral health entities to be owned by medical professionals who are duly licensed or otherwise legally authorized to render professional medical services. This requirement is often referred to as the corporate practice of medicine doctrine. In order to comply with the corporate practice of medicine doctrine, financial investors may need to set up legal entity/ownership structures, whereby a private equity owned management company and the existing medical practice operate under the governance of various agreements. The formation of these structures, the ongoing operations, and the exit from these structures can have adverse tax implications for both buyers and sellers if not carefully structured and reported.

Independent contractors—Many behavioral health entities utilize medical professionals and treat them as independent contractors. The proper classification of an individual as an independent contractor vs. an employee is highly dependent on the facts and circumstances. A company that misclassifies certain individuals as independent contractors may be subject to income tax withholding exposure and payroll tax exposure, which could be sizeable depending on the number of independent contractors and the lengthy statutes of limitations. Underpayment of payroll taxes could also impact a target company's quality of earnings.

Regulatory and compliance

Billing and coding chart audit—Behavioral health typically has a high percentage of patients on Medicaid and Medicare. Regulatory diligence is an important diligence focus area as improper billing of Medicare and Medicaid can result in significant fines and penalties. Performing a billing and coding chart audit is a critical step in diligence. This typically includes selecting a sample of patient records and their related Medicare & Medicaid billing documents to determine if the company has documented evidence of services being performed for the services that are billed.

Other billing considerations—The Centers for Medicare & Medicaid Services recently changed the codes used by behavioral health providers, and psychiatrists recently began using evaluation and management (E&M) codes to report all medical services. Some providers have experienced increased error rates with this transition. Compliance diligence should determine if providers and their billing staff have received requisite training to accommodate these changes.

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