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How to Navigate a FMV Opinion for Transactions & Compensation Arrangements

ABA Health Law Section

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- Leads Professional Services Agreement Division (11 years), oversees approximately 80 valuations per month

- Published and presented related to Fair Market Value (FMV) and physician compensation over 50 times
  - Organizations include: Centers for Medicare and Medicaid Services, American Bar Association, American Health Lawyers Association, Becker's Hospital Review, Healthcare Financial Management Association & Healthcare Compliance Association
  - Co-present with government, hospital leadership, and counsel

- Served as Fair Market Value expert witness and peer review editor for the Journal of Hospital Administration

- Previously with KPMG's litigation department and held position as finance professor at the University of North Texas

- Relevant experience - recent research/emphasis related to pay for performance compensation, including over 200 co-management valuations, ACO/CIN payment allocations & HEIPs

Aaron Murski, CVA

- Managing Director overseeing business valuation, consulting, and research teams within VMG health

- Published, presented, and interviewed over 30 times, related to Fair Market Value (FMV), benchmarking, and business transactions in healthcare services
    - Organizations include: Becker's Hospital Review, Journal of Corporate Renewal, The Ambulatory M&A Advisor, Ambulatory Surgery Center Association

- Wide range of valuation assignments, commonplace to complex, including intellectual and intangible asset contributions, for health systems and networks

Presentation Overview

- Compliance Basics & Importance of a Solid FMV
- Engaging an Appraiser
- Navigating FMV Opinions
- Checklist

Compliance Basics & Importance of a Solid FMV

Compliance Basics - Commercially Reasonable

- *An arrangement will be considered "commercially reasonable" in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician (or family member or group practice) of similar scope and specialty, even if there were no potential DHS (designated health services) referrals. (69 Federal Register (March 26, 2004), Page 16093)*
  - Pre-cursor to determining FMV
  - Arrangement must make business sense absent considering referrals
  - Hospital leadership must understand this standard since they will primarily be the individuals who assess CR. **Sample** considerations:
    - Operational assessment – does the community need this service/number of specialists?
    - Physician requirements – are the number of hours required?
    - Financial options – can you lease equipment from a third party vendor at a better rate than from a physician group?
  - Counsels role – did hospital leadership walk through the business considerations?
  - Valuation firm role – is the compensation at FMV?
  - ROBUST analysis on file is best practice – address organizational, service line and specific terms associated with the CR standard.

What is Fair Market Value?

"Fair Market Value" is defined in Stark, 42 U.S.C. 1395nn(h)(3), as the value in arms-length transactions, consistent with the general market value…the compensation that would be included in a service agreement as the result of a <u>bona fide bargaining</u> between well-informed parties to the agreement <u>who are not otherwise in a position to generate business for the other party</u>, on the date of acquisition of the asset or at the time of the service agreement. (42. C.F.R. 411.351)

Stark II Phase II Commentary adds this clarification:

- *The methodology must exclude valuations where the parties to the transactions are at arm's-length but in a position to refer to one another. (69 Federal Register (March 26, 2004), Page 16107)*

Preamble Stark Phase I Commentary adds this clarification:

- *Depending on the circumstances, the "volume or value" restriction will preclude reliance on comparables that involve entities and healthcare providers in a position to refer or generate business. (66 Federal Register (January 4, 2001), Page 945)*

Compliance Basics - Fair Market Value

- **Agreements and transactions should carefully be constructed**
  - Do not consider referrals when establishing transaction price.
  - Do not consider referrals when establishing compensation <u>or</u> when setting mechanism to drive compensation.
  - Carefully construct alternative payment models (gainshare, MSSP, ACO, bundled payments) since often tied to other (non-physician) income streams.

- **Do not determine FMV based on**
  - What the hospital next door is paying or a physician's "going rate".
  - Non-comparable multiples in a transaction
  - Non-comparable services and associated fees (ie: management vs. co-management).

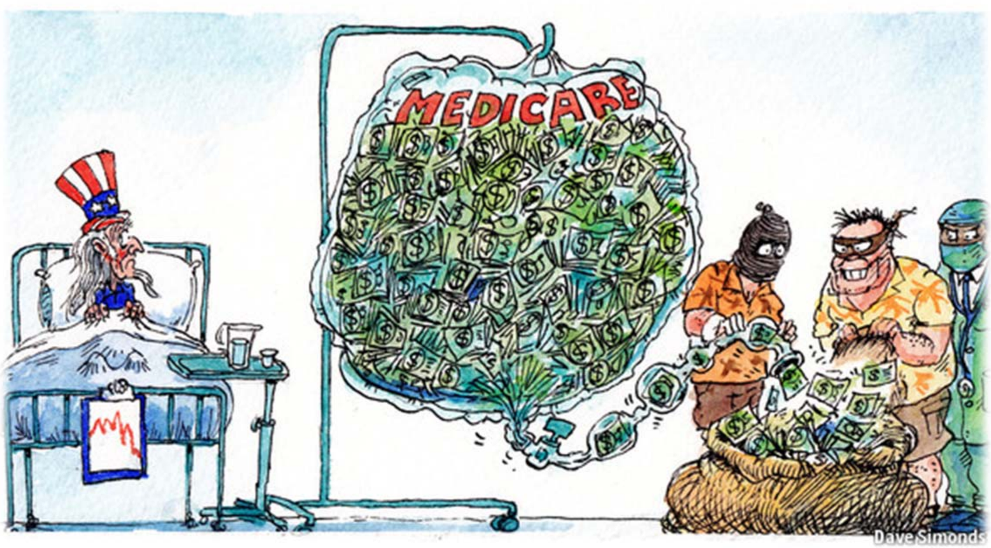
Recent Regulatory Scrutiny

✓ **Huge surge in Qui Tam suits, material settlements & personal accountability**

✓ **Growth in federal funding for fraud and abuse investigations**

- Settlements earned 25% more in 2016 over 2015 ($4.76 billion FCA)
- For every $1 spent on healthcare fraud related investigations, government recovers $6.10

✓ **FMV (and CR) opinions shows up in settlements**



Sample Cases with Unsupportable FMVs

- ✓ **Tuomey (2013)**:
  - Valuation was approximately 3.5 pages
  - Unreasonable assumptions (e.g. not normalizing down full-time benefits)
  - Report considered a more “qualitative” approach and analysis
- ✓ **Michael Crocker, MD vs Greater Colorado Anesthesia, PC (“GCA”) (2015)**
  - Valuation section is 8 pages, versus 15 pages of Industry & Economic Analysis
  - Valuation section primarily boiler plate, many assumptions and adjustments are not discussed/supported
  - Vague explanation and mathematical errors for financial projections
  - Inaccurate assumptions
- ✓ **U.S. ex. Rel. Konsenske v. Carlisle HMA (2009)**
  - FMV was not updated with most recent assumptions
  - Hospital built a nearby facility after agreement was signed, was not updated to include the free space, equipment and staff
- ✓ **Bradford RMC involved in equipment sublease (2010)**
  - Sublease and non-compete for a nuclear camera
  - Hospital’s position: Fixed fee does not vary, hence isn’t based on referral volume/ value
  - Not FMV: Non-compete valuation considered anticipated referrals to the hospital and lost profits of the physicians
  - Not CR: Hospital admitted nuclear camera wasn’t needed, and wasn’t relocated to the hospital or used until after a few months

Key Takeaways from Recent Cases

- ✓ Inaccurate assumptions not OK
- ✓ Must consider all facts and circumstances
- ✓ Ensure calculation accuracy
- ✓ Periodically reevaluate opinions
- ✓ Valuation should match agreement
- ✓ Examine the economic and operational reasonability of an arrangement (CR)
- ✓ Do not consider referral volume or value when determining FMV
- ✓ No opinion shopping

Engaging an Appraiser

Selection Process - *Sample Qs*

Experience:

1. Does valuation analyst have appropriate credentials (e.g., CFA, CPA, ASA, CVA, etc.)?
2. Does the valuation analyst have significant experience in health care in a valuation capacity?
3. Can the valuation analyst provide references or a list of prior valuation assignments specific to healthcare and specific to the "sub-industry" (e.g., ambulatory surgery center, acute care hospital, laboratory business, etc.) of the subject arrangement?

References:

1. Was the engagement completed timely?
2. Was the appraiser's conduct professional?
3. Was the deliverable of high quality and easy to understand?

Initial Contact:

1. Is the information request thorough?
2. Is anything outsourced?
3. Can the appraiser explain the scope of the engagement and what you need to obtain a proper defensible opinion?

Navigating FMV Opinions

Business Valuation FMV – IRS Rev Ruling 59-60

Approach

"No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."

Should consider…

Not Exhaustive

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Rev. Rul. 59-60, 1959-1 CB 237 -- IRC Sec. 2031 (Also Section 2512.) (Also Part II, Sections 811(k), 1005, Regulations 105, Section 81.10.)

Business Valuation FMV – Where to begin?

Identification of the business and subject interest

- Existing business versus "NewCo" / carve out
- Size of ownership interest – 1%, 25%, 51%, etc.
- Legal structure and implications
    - Limited Liability Company
    - Limited Partnership – GP interest vs. LP interests
    - Corporation

Valuation Date

1. Current date vs. historical date
2. Consider what is "known or knowable" as of the valuation date
3. "Shelf life" of valuation – no set standard, judgment involved

Business Valuation FMV – Where to begin?

Purpose of Valuation

- Regulatory compliance
- Litigation support
- Other?

Intended Users

- Clearly identified – restricted to purposes/audience
- Person requesting, organization, board?
- Attorney: requested by legal counsel in connection with providing legal advice – “Privileged & Confidential”
- Implications for how it is used or relied on

Business Valuation FMV – Standard / Premise

Standards of Value

- Fair Market Value
- Strategic or Investment Value
- Intrinsic Value
- Fair Value – Statutory
- Other?

Premise of Value

- Business valuation: 2 main premises – Going Concern vs. Liquidation
- Liquidation: Orderly v. Forced
- Additional premises, e.g., for specific asset appraisal

Business Valuation FMV – Level of Value

Control vs Minority

Correlated to ownership size or rights/restrictions?

Traditional[1]

Strategic Value

↓

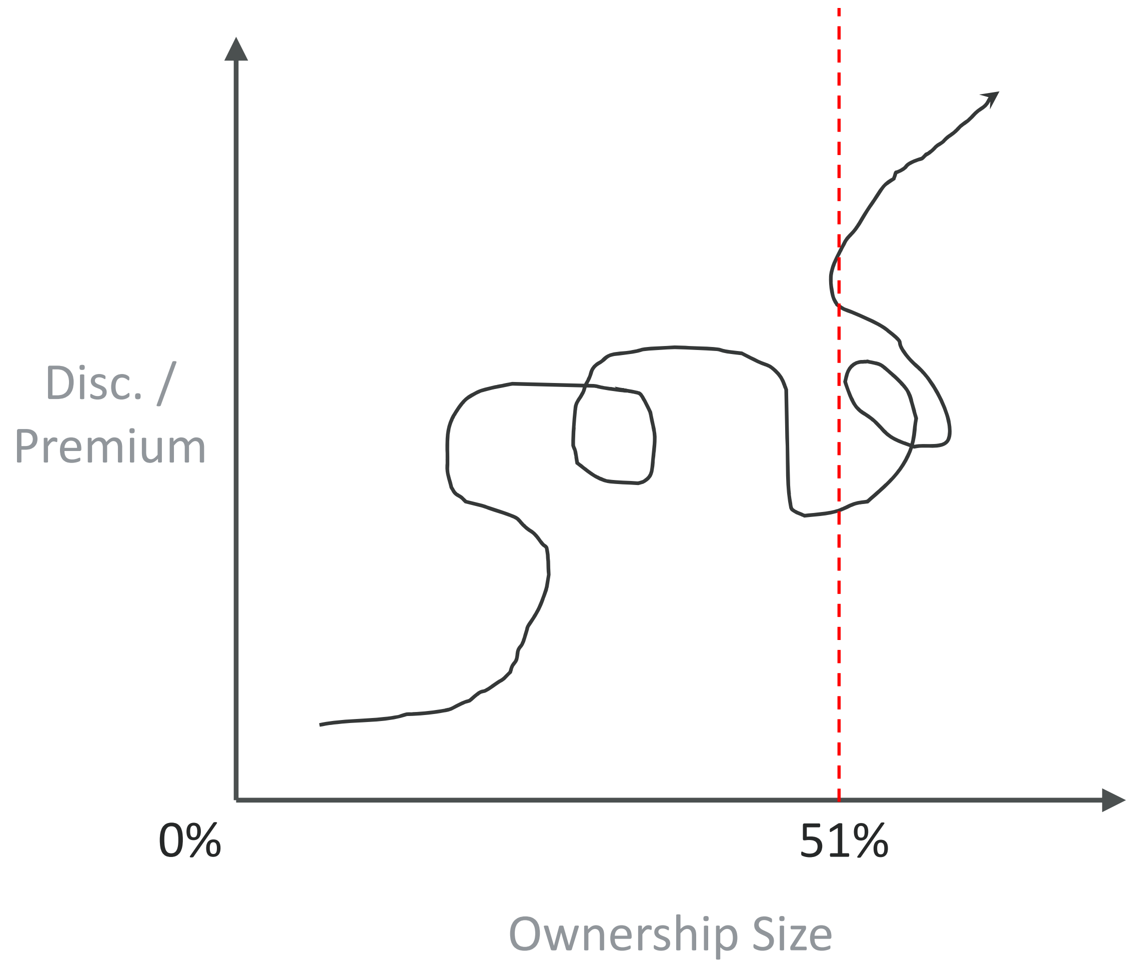
Control Value

↓

Minority Value, Marketable

↓

Minority Value, Non-Marketable



(1) John Stockdale Sr. BVR's Guide to Discounts for Lack of Marketability, Volume 1 (Fourth Edition, page 22).

Business Valuation FMV – 3 Approaches

Cost Approach

- Can be thought of as a “build-up” – identify and value asset used in the business
- Tangible property – equipment, furniture, real estate?, working capital (AR, inventory, accounts payable, etc.)
- Identified Intangible Assets

Market Approach

- 2 general methods: Guideline Public Company and Merger & Acquisition
- Revolves around concept of comparability
- Public company data / challenges
- Private market M&A data / challenges

Income Approach

- Future economic benefits – typically cash flow – is discounted to present value
- Multi-period forecast vs. Single period capitalization
- Discount rate selection

Business Valuation FMV – Deal Structure

Transaction Structure

- Traditionally: Asset Purchase vs. Stock Purchase
- Valuation parameters should consider deal structure
- Practically: add
  - Contribution of "assets" to NewCo / Cash
  - Relative valuation – contribution of businesses or assets to NewCo by each party
  - Consider post-transaction agreements (e.g. physician comp, FMV rent, shared services, etc.)
- Not-for-profit / For-profit issues – tax affecting / income approach

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Business Valuation FMV – Red Flags

1. **"Make sure you include our [the buyer's volume, revenue, expense, etc.] impact in the valuation…"** FMV vs Strategic Value

2. **"We want to sell this [10%] interest for a premium, they are a competitor…"** Level of value – control vs. minority

3. **"Our [NFP / for-profit / public company] cost of capital is [10%], you should use that for the discounted cash flow…"** FMV vs Strategic Value, level of value

4. **"We are a not-for-profit, you should remove taxes…"** Tax exempt assets don't trade at a premium, matching benefit stream to discount rate (both after-tax or both pre-tax), FMV

5. **"We want to use the FMV valuation process to negotiate the deal price…"** FMV vs. Strategic Value, independence of parties to a deal

Business Valuation Opinions – Types & Tips

1. **Physician Practices -** In the determination of FMV, it is critical to understand the relationship between provider compensation and productivity.
2. **Urgent Care Centers and Freestanding Emergency Departments** - Significant risk factors associated with UCCs and FSEDs include the high levels of competition associated with relatively low barriers to entry and community acceptance related to the higher co-pays.
3. **Diagnostic Imaging Centers -** Typically capital intensive entities and can be limited by capacity and technological constraints. The maintenance and replenishment of the imaging equipment asset base should be addressed in the valuation.
4. **Laboratory Services -** Due in part to the continued growth in lab volumes and relationships between labs and referring physicians, and the OIG's position that the potential exists for fraud and abuse in the industry, any direct or indirect financial relationships between a laboratory and referring physicians should be disclosed, in order to evaluate the risk profile of the subject lab business
5. **Ambulatory Surgery Centers -** A key factor in the valuation of an ASC is understanding the physician utilizer attributes, such as ownership percentage, age, specialty, and any expected changes in practice patterns.
6. **Radiation Therapy –** Since it is a capital intensive business, future capital expenditures required to maintain current assets and fund new equipment must be addressed in the FMV analysis

Business Valuation Opinions – Types & Tips
Continued…

1. **Hospitals -** Hospitals often rely on subsidy payments from their state and the federal government. The valuation analyst should understand the source and amount of these payments so to evaluate the future risk of these dollars.
2. **Inpatient Rehabilitation Facilities -** Market-level reimbursement, not hospital-based, should be at the forefront of the analysis of an IP Rehab. The FMV of any IP Rehab has to consider the reimbursement any willing market participate can achieve, not a specific buyer/seller.
3. **Dialysis –** Typically rely disproportionately on a small minority of patients covered by commercial payors in order to generate a profit. Therefore, understanding the current and projected commercial patient base is crucial to any dialysis center valuation.
4. **Home Care Services** - Due to the low cost per day of Home Care relative to other settings (e.g., Hospital, Skilled Nursing), continually improving medical technology, and the imperatives of healthcare reform and the "triple aim", the Home Care industry may see continued growth and expansion by taking market share from other healthcare verticals.
5. **Long Term Acute Care Hospitals -** The FMV analysis must address the impact of significant new regulations such as the 25% Rule and Site Neutral Payments, on future operations.

Compensation Arrangements Basics

Step 1: *What are you paying for?*

- Is there an agreement in place, or term sheet to review?
- Is the agreement structured properly and approved by legal (% structure, no referral tie)?
- Is each service to be provided described in the agreement?
- Has the proposed compensation been determined based on a consistent and compliant method, with no consideration of referrals?

Step 2: *Does the valuation make sense?*

- Has the valuation considered a market, cost and/or income approach for each service?
  - ✓ How truly comparable are any market data points? This guides how much weight should be placed on the market approach.
  - ✓ How much would it cost if the health system went another route to get the services?
  - ✓ Does the report apply multiple valuation approaches with the most weight applied to the best approach?
- Have the assumptions been approved by the appropriate parties?
- Are the assumptions reasonable?
- Does the valuation report tie to the agreement fees and services?

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Agreement Valuation Opinions – Types & Tips

1. **Clinical Services -** Compensation practices for employed physicians are shifting to match the current reimbursement landscape. Greater portions of a physician's clinical compensation will be determined based on value or positive patient outcomes versus volume of care.
2. **Medical Directorships & Physician Executives-** As hospitals and health systems move from volume-based reimbursement models to value-based, there is a growing need to engage and utilize the expertise of qualified physicians in administrative and leadership roles, tracking time for hourly services is important for compliance purposes.
3. **Administrative (Management and Billing Services) -** Having a detailed list of services in a term sheet or agreement is key for the valuation of an administrative services fee. The services provided dictate the appropriate valuation approaches employed and relevance of market comparables
4. **On-Call Coverage-** The OIG has outlined burden of call factors which need to be addressed in an FMV analysis
5. **Telemedicine -** Compensating physicians for telemedicine services should consider the relative potential reimbursement from third party payors & patients associated with the service along with the response burden incurred by the physicians in providing the coverage.
6. **Hospital-Based Coverage (Subsidy)** – The physician expense is generally the primary expense and should be analyzed to ensure reasonability based on the contracted coverage hours and expected productivity.

Agreement Valuation Opinions – Types & Tips
Continued…

1. **Professional Interpretations/Read Fees -** Professional fee arrangements should establish fees based on the relative case/scan mix at the site of service in relation to how governmental and non-governmental payors are reimbursing for similar services.
2. **Pay for Performance (Quality and Cost Savings) P4P -** Compensation varies widely in services and fee structures. It is important to consider the financial risk and responsibility of the parties prior to determining how to allocate and/or value these payments.
3. **Life Sciences Physician Compensation -** The Sunshine Provision has brought physician payments from industry to the forefront of regulatory scrutiny, use a thorough methodology.
4. **Real Estate -** Understanding true market comparables is important when determining the FMV for various types of healthcare facilities, a medical office building is very different than a radiation therapy center.
5. **Capital Assets (Fixed Assets) -** There are many different definitions of value associated with Capital Asset valuation and correctly understanding the scope, methodology and analysis will assist the reader in understanding the analysis
6. **Medical Office Timeshares -** Time Share valuations should consider all the terms, services and space outlined in the agreement.

Reviewing a Valuation - Checklist

GENERAL – ALL VALUATIONS

1. Determine CR.
2. Ensure terms of transaction or agreement are clearly outlined.
3. Verify appraiser has appropriate credentials and understands the scope of the engagement, as well as FMV defined in healthcare.
4. Appropriate parties should confirm assumptions.
5. Understand the methodology - is the valuation opinion thorough, logical, supportable and explainable?

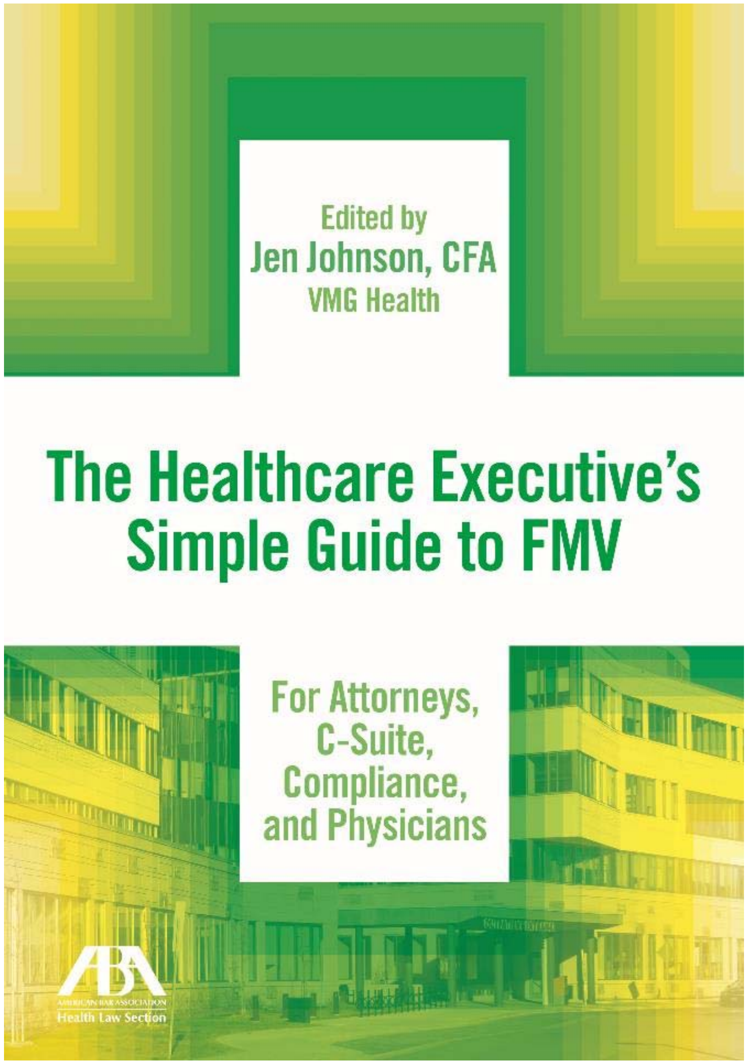
BUSINESS VALUATION

1. Cost Approach, Market Approach and Income Approach should be considered.
2. Understanding of the vertical/sector is demonstrated (ASC, Imaging, Physician Practice, etc…) in the report.
3. Value drivers are addressed, including: payor mix, case mix, volume, staffing, capital expenditure requirements, service area demographics, and competitive factors.

AGREEMENT VALUATION

1. Structure is consistent with regulatory guidelines (% v. fixed).
2. Agreement terms and services are clearly identified and tie to valuation method.
3. Understand market comparables for services (i.e.: management vs co-management, etc…), and if there are none, a cost approach should be considered.

Questions?



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