Fair Market Value in Today's Healthcare Transaction Environment: FMV's Gone Wrong and the Government's Attempts to Expand Liability

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VMG Health

Introduction – VMG Health

For over 20 years VMG Health has focused exclusively in healthcare fair market value services to become the recognized leader in valuation and transaction advisory in the industry. In 1995, VMG Health was created by its two founders as the first and only healthcare specific valuation consulting firm. Since then, the company has grown to over 140 professionals, with offices in Dallas, Denver and Nashville.

As a full-service valuation firm, VMG Health focuses on meeting the healthcare industry's exclusive needs by offering a unique combination of services that cannot be found elsewhere. We pride ourselves on providing clients with a single source for all of their valuation and transaction advisory services and continue to expand our offerings to evolve with the ever-changing healthcare environment. Some areas of expertise include health system and hospital valuation, hospital and healthcare tangible property appraisal, healthcare transaction consulting, financial reporting valuation for healthcare mergers and acquisitions, physician compensation valuation, medical office building appraisal, litigation advisory and dispute resolution, and transaction advisory and joint venture development.

PRESENTATION OUTLINE

1) Applicable Laws and Fair Market Value

2) What's Gone Wrong and How Has Liability Expanded?

3) As a Healthcare Attorney, What Can I do About It?

4) Question & Answer

Applicable Laws and Fair Market Value

APPLICABLE LAWS

The healthcare industry is heavily regulated and these regulations help guide the transaction environment.

Stark Law (42 CFR § 411.351)	➢ *Prohibits physicians from referring a patient to an entity with which the physician has a financial relationship, when the referral is for the furnishing of certain designated health services (DHS) (e.g., lab, PT, OT, radiology, DME, inpatient services, etc.).* ➢ *Civil Penalty*
Anti-Kickback Statute (42 U.S.C. § 1320a-7b)	➢ *Prohibits the payment or remuneration in exchange for, or in order to induce, the referral of patients or other businesses which are reimbursed under the Medicare program.* ➢ *Criminal Penalty*
Private Inurement Statute (Regs. 1.501(c)(3)-1(c)(2))	➢ *Tax-exempt entities cannot provide excess benefits to non tax-exempt individuals or entities.*

Applicable Laws

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The healthcare industry is heavily regulated and these regulations help guide the transaction environment.

Commercial Reasonableness (69 FR at 16093)	➢ *Acquisition or arrangement must make commercial sense even if there were no potential DHS referrals.* ➢ *Sometimes viewed as a pre-cursor to determining FMV.*
Recent Attempts to Expand Liability	➢ *Individuals increasingly at risk* ➢ *State bribery laws invoked when unable to utilize Stark, Anti-Kickback* ➢ *Simultaneous civil, criminal, and administrative investigation of same defendants*

APPLICABLE LAWS

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Fair Market Value – IRS Definition

"The price, expressed in terms of cash equivalents, at which a property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy nor to sell, and when both have reasonable knowledge of the relevant facts. (*IRS Rev Ruling 59-60)*

General Market Value – Stark Law Definition

"The price that an asset would bring as the result of bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of the acquisition of the asset or at the time of the service agreement. Usually, the fair market price is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition….**where the price or compensation has not been determined in any manner that takes into account the volume or value of anticipated or actual referrals**."(*42 C.F.R. 411.651*)

APPLICABLE LAWS

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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 referrals." (*69 Federal Register (March 26, 2004), Page 16093)*

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How do these statutes affect the terms of the transaction?

Buyers of healthcare entities often have to comply to this regulatory framework.

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The transaction must be priced at Fair Market Value (FMV).

Fair Market Valuations Gone Wrong

Assumptions Must be Supportable AND Supported

- ✓ **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

- ✓ **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

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Real People, Real Consequences

Tuomey
Hospital settled case and over one year later - former CEO fined $1 million

North American Health Care
False claims to government health care programs for medically unnecessary rehabilitation therapy services - chairman of the board agreed to pay $1 million and the senior vice president agreed to pay $500,000.

Recovery Home Care
Former Owner, Mark T. Conklin allegedly paid dozens of physicians thousands of dollars per month to serve as sham medical directors - agreed to pay $1.75 million to settle lawsuit.

2015

2016

Sacred Heart Hospital
Former executives and physicians for alleged role in orchestration and participation in unlawful kickback compensation schemes - convicted and sentenced to prison terms.

Columbus Regional (Georgia)
Claims for payment to federal health care programs that misrepresented the level of services they provided - Dr. Pippas to pay $425,000.

Physician Assistant
Kyle D. Gandy - Sentenced to 14 months in prison and ordered to pay $18,030 in restitution for accepting illegal kickbacks for referring patients to medical clinics, physical therapy clinics, and a home health care agency.

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Five Key Takeaways from Recent Case Law

1. **Services Must Be Provided**

   United States ex rel. Williams v. Health Management Associates, Inc. (2014)

2. **Do Not Base Pay on Referrals**

   United States ex rel. Drakeford, M.D. v. Tuomey (2013)

3. **Arrangement Must Be Reasonable**

   United States v. Campbell (2011) & United States ex rel. Singh v. Bradford Regional Medical Center (2010)

4. **Must Reflect Actual Deal**

   United States ex rel. Kosenske, M.D. v. Carlisle HMA, Inc. (2009)

5. **Listen to Good Advice**

   United States ex rel. Pogue v. Diabetes Treatment Centers for America (2008)

Five Key Takeaways

1 Services Must Be Provided

United States ex rel. Williams v. Health Management Associates, Inc. – 2014

- Compensation is not FMV if hospitals are overpaying for services or paying for services that were not provided
- Atlanta Medical Center paid Clinics $42,350 per month for the operation and management of the residency clinic, but the residency clinic only generated $20,000 per month
- North Fulton and HMA paid for services that the Clinic did not provide, such as Spanish-interpretive services

Five Key Takeaways

2 Do Not Base Pay on Referrals

United States ex rel. Drakeford, M.D. v. Tuomey – 2013

- Judgment against Tuomey for $237,454,195
- If compensation takes into account the volume or value of referrals then the compensation is not at FMV
- There was a one-to-one relationship between each doctor's aggregate compensation and the volume or value of the doctor's referrals to the hospital

Expert Opinions

- *Richard Philip Kusserow - Compensation agreement lacked specificity of the physician's duties and responsibilities, and it was not clear what the physicians were getting paid for; physicians getting paid more than the national survey rate*
- *Kevin McAnaney - Physicians were making more than they were collecting, which could be evidence that the compensation was above FMV; red flag that Tuomey was going to lose money on the compensation arrangements*

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Five Key Takeaways

3 Arrangement Must Be Reasonable

United States v. Campbell – 2011

- Campbell was not required to fulfill the services set forth in his employment agreement
- A salary of $75,000 annually could be reasonable for his position, but the compensation is not at FMV if there are no requirements to actually perform the duties

United States ex rel. Singh v. Bradford Regional Medical Center – 2010

- The compensation arrangement is above FMV, because it takes into account the volume or value of anticipated or actual referrals
- BRMC and the physicians agreed to the value of the non-compete clause based on the business the physicians would lose from not using the GE camera themselves and the value BRMC will gain from the physicians' referrals
- BRMC gave V&S 10% of all amounts collected on referrals to the GE machine; the payment changed based on the value or volume of referrals

Five Key Takeaways

4 Must Reflect Actual Deal

United States ex rel. Kosenske, M.D. v. Carlisle HMA, Inc. – 2009

- The 1992 written agreement did not mention or include the stand alone facility built in 1998, so there is no indication that the 1992 agreement considered the FMV of the services performed at the stand-alone facility in 1998
- Valuation did not take into consideration BMAA's free use of the stand-alone facility and the exclusive contract, so it was not a good indicator of whether the compensation arrangement was FMV

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Five Key Takeaways

5 Listen to Good Advice

United States ex rel. Pogue v. Diabetes Treatment Centers for America – 2008

- The scope of medical directors work, prevailing rates of compensation for comparable positions, and inconsistency in compensation were factors considered in determining that the compensation arrangement was not FMV
- The hospital ignored its counsel's repeated advice to require the medical directors to maintain time logs and to obtain a fair market value assessment
- Instead of getting an actual FMV opinion they used a "market analysis" based on "personal judgment" and "rule of thumb"

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DOs	DON'Ts
✓ Must consider all facts and circumstances	✘ Inaccurate assumptions are not okay
✓ Must ensure calculation accuracy	✘ No opinion shopping
✓ Periodically reevaluate opinions	✘ Do not consider referral volume or value when determining FMV in healthcare setting
✓ Valuation should match/align with agreement	
✓ Examine economic and operational reasonability of an arrangement (commercially reasonable)	

Recent Attempts to Expand Liability

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Recent Attempts by Government to Expand Liability

Yates Memorandum

- "Individual Accountability for Corporate Wrongdoing"
- Emphasizes DOJ's commitment to combat fraud "by individuals"
- Recommends:
  - *Not to give cooperation credit unless company provides facts about specific individual activity*
  - *Focus investigations on individuals "from the inception"*
  - *Not to release "culpable individuals" from liab. absent "extraordinary circumstances"*
  - *Not to settle with company without "clear plan to resolve related individual cases"*

Parallel Proceedings

- Simultaneous civil, criminal, and administrative investigation of same defendants
  - *Usually jointly handled*
  - *Either federal or state and local*
- Examples include:
  - *Health care fraud*
  - *Asset forfeiture actions*
  - *Drug diversion*
- Challenges include:
  - *Stifles ability to settle civil case*
  - *Forces defendants to plead the 5th*
  - *Lengthens settlement discussions and resolutions*

Travel Act (18 U.S.C. § 1952)

- Gov't asserting claims under Travel Act when unable to utilize Stark, Anti-Kickback, or False Claims
- Prohibits using mail or any facility in interstate commerce (e.g., mail, email, phone, wire transfer) with the intent to further any "unlawful activity" or distribute the proceeds thereof
- Examples:
  - *Forest Park Medical Center*
  - *Biodiagnostic Laboratory Services*
  - *US v. Garcia; US v. Grusd; US v. Reese, et al*
- Implication: certain arrangements may still be at risk if not compliant with state bribery laws

Valuation Overview

VALUATION PROCESS

I. Investigation	II. Analysis	III. Valuation

The valuation process involves the following steps in order to assess the value of the target **to a hypothetical third-party investor**.

- Interview or conduct diligence with key management in order to develop an understanding of the strategic position of the target
- Evaluate historical financial results and statistics
- Gain understanding of opportunity with the target from a market participant perspective

In order to maintain independence, direct access to the target and full disclosure of diligence efforts is necessary.

VALUATION PROCESS

I. Investigation | **II. Analysis** | III. Valuation

A detailed analysis of the historical operating and financial data must be conducted in order to gain an understanding of the operations of the target. For example, the following are examples of documentation that serve as direct inputs to our models

- Analyze historical operational results and statistics
  - Payor and service mix
  - Managed care relationships
- Prepare prospective operational and financial analysis
  - Volume and revenue
  - Staffing
  - Cost projections
  - Capital expenditure requirements
  - Working capital requirements
- Evaluate service area demographics
- Evaluate competitive factors
- Complete site visits on select locations and interview with key personnel

VALUATION APPROACHES

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Three Approaches to Valuation	
Income Approach	➢ Discounted Cash Flow Method
Cost Approach	➢ Tangible Assets (working capital, fixed assets, real estate) ➢ Intangible Assets (trade name, phone number, medical charts, trained workforce)
Market Approach	➢ Guideline Public Company Method ➢ Merger & Acquisition / Similar Transaction Method

Valuation Approaches

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Income Approach

Present Value of Future Cash Flows

- Projection of future revenues and expenses
- Projection of future capital expenditures and working capital requirements
- Post-transaction provider compensation

	Normalized	Projection Period					Terminal
	Base Year	Year 1	Year 2	Year 3	Year 4	Year 5	Year
Revenues:							
Total Net Operating Revenue	5,470,811	5,690,466	5,873,144	6,056,686	6,197,362	6,335,830	6,494,226
Operating Expenses:							
Total Operating Expenses	3,010,354	3,101,442	3,187,372	3,274,655	3,355,839	3,437,892	
Pre-Compensation Earnings	2,460,457	2,589,024	2,685,772	2,782,031	2,841,523	2,897,938	
Provider Compensation							
Total Provider Compensation	2,114,515	2,199,690	2,270,329	2,341,418	2,395,789	2,449,426	
EBITDA	345,943	389,334	415,443	440,613	445,734	448,512	459,725
Depreciation & Amortization Expense	12,469	18,469	30,469	30,000	42,000	54,000	75,000
Interest Expense	-	-	-	-	-	-	-
Federal & State Income Tax Expense @ 38.58%	128,657	143,080	148,523	158,414	155,760	152,203	148,427
Earnings After Income Taxes	$204,818	$227,785	$236,451	$252,198	$247,973	$242,309	$236,298
Cash Flow Adjustments:							
Plus: Depreciation & Amortization		18,469	30,469	30,000	42,000	54,000	
Less: Required Annual Capital Expenditures		(60,000)	(60,000)	(60,000)	(60,000)	(60,000)	
Less: Incremental Working Capital Requirements		(13,179)	(10,961)	(11,013)	(8,441)	(8,308)	(9,504)
Net Discretionary Cash Flow		173,075	195,959	211,186	221,533	228,001	226,794
Terminal Value							1,972,123
Sum of Present Values (Year 1 to Year 5)		741,769	40.4%	*1.9x*	*YR 1 EBITDA*		
Present Value of Terminal		1,093,609	59.6%	*2.8x*	*YR 1 EBITDA*		
Fair Market Value Indication (Total Invested Capital Level)		*1,835,378*	*100.0%*	*4.7x*	*YR 1 EBITDA*		

*Cash flows exclude non-recurring revenues and expenses **and synergies***

Present Value of Cash Flows = Value Indication

Valuation Approaches

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Income Approach (continued)

Underlying Assumptions

Volume

Reimbursement

Post Transaction Compensation

Expense Forecast

Capital Expenditures

Cost of Capital

Cost of Equity

Cost of Debt

VALUATION APPROACHES

Cost Approach

Considers the cost of replicating a comparable asset, security or service with the same level of utility. Typically used when the entity has historical losses or nominal projected cash flow.

Tangible Assets

- Working capital
- Fixed assets
- Real estate (if applicable)

Intangible Assets

- Legal title, protectable, separately marketable
  - *Trade name*
  - *Covenants not to compete*
  - *Trained Workforce*

Valuation Approaches

Market Approach

Compares the value of similar assets, securities or services traded in a free and open market to the subject asset, security or service.

Guideline Public Company Method

It can be difficult to utilize the multiples of publicly-traded companies due to lack of comparability from a size or growth standpoint

Merger & Acquisition Method

There is a wide range of observed transaction multiples. Often this information is difficult to compare to a specific entity or transaction.

*Market Approach can be used as a determinant of FMV for **select** acquisitions.*

VALUATION COMPONENTS

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Typical Components of a Transaction

Total Value
- Working Capital
- Fixed Assets
- Intangible Assets (Goodwill)

Retained by Seller
- Working Capital Less Inventory
- Personal Fixed Assets

Purchased by Acquirer
- Inventory
- Fixed Assets
- Intangible Assets

VALUATION CONSIDERATIONS

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Fair Market Value vs. Strategic / Investment Value

Examples of common valuation considerations include the following:

Fair Market Value	Strategic / Investment Value
✓ Adjusting reimbursement rates to market participant rates	✗ Adjusting reimbursement rates to acquirer's contracted rates
✓ Market participant cost savings	✗ Acquirer specific cost efficiencies
✓ Fair market value rent rate	✗ Related-party rent arrangements
✓ Post-Transaction compensation	✗ Pay for referrals

VALUATION CONSIDERATIONS

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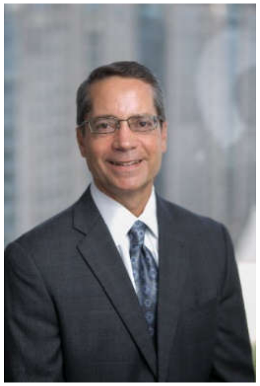
Fair Market Value in the Context of a Transaction

1. *Post-Transaction compensation for shareholders (i.e., physician compensation)*
2. *Understanding of employed physicians compensation (i.e. is it sustainable given production levels).*
3. *Similar consideration should be applied to management services arrangements, if related party*
4. *Rental agreements, if related party.*
5. *Working with deal team on identified due diligence items.*

Question and Answer

BIOGRAPHIES



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Don Barbo is a managing director with VMG Health. He specializes in healthcare business valuations involving mergers and acquisitions, divestitures, partnership transactions, leasing arrangements, commercial damages, and financial reporting. His extensive healthcare valuation engagements have included hospitals (acute care, long-term care, critical access, and surgical), physician practices (variety of primary care and hospital-based), ambulatory surgery centers, diagnostic imaging centers, cardiac catheter labs, pathology and clinical labs, cancer treatment centers, and dialysis centers. Mr. Barbo has also performed engagements for various contracts between hospitals and physicians, including medical director agreements, on-call agreements, lithotripsy service agreements, purchase services agreements, and management services agreements.

Mr. Barbo has spoken extensively to various legal and valuation organizations and has published articles regarding business valuation issues. He also serves as an expert witness in litigated matters for his clients, including testifying before the U.S. Tax Court.

Mr. Barbo has been performing healthcare valuations since 1998. Prior to his valuation career, he served as the chief financial officer for a physician practice management company that provides management services to a variety of physician practices. Before that, he served as the controller/financial officer for various emerging companies. He began his professional career as an auditor with an international accounting firm.

Mr. Barbo is a CPA, holds the Accreditation in Business Valuation from the AICPA, is a member of the Medical Group Management Association (MGMA), and a member of the Healthcare Financial Management Association (HFMA). He also serves on the Technical Advisory Board for the AICPA's Forensics & Valuation Section Consulting Digest. He holds a BBA in Accounting from Texas Tech University, and an MBA from the Cox School of Business, Southern Methodist

Awards and Honors:

- Recognized by the Dallas Business Journal as 1 of 25 recipients on its annual "Who's Who in DFW Health Care" for 2014; announced October, 2014
- Recognized by Nightingale's Healthcare News as 1 of 10 recipients on its 2010 "People to Watch in Healthcare Transactions in the Southwest", May 5, 2010, Southwest Healthcare Transaction Conference, Dallas, TX

Biographies

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John Meindl is a director with VMG Health and is based in the Dallas office. In addition to providing valuation and transaction advisory services, Mr. Meindl is also involved in the firm's Dispute Resolution and Litigation Advisory service line.

Mr. Meindl's valuation experience includes providing advisory services for management planning, dispute resolution, transaction advisory, financial reporting, and tax purposes. Mr. Meindl's healthcare experience includes the valuation of hospitals and health systems, ambulatory surgery centers, physician practices and organizations, laboratories, management companies, dialysis centers, and other healthcare entities. He has provided dispute resolution and advisory services in matters including lost profits, business interruption, breach of contract, fraud, clinical compensation disputes, trademark infringement, patent infringement, and breach of fiduciary duty, among other various matters involving public and private entities.

Prior to VMG Health, Mr. Meindl was with Ernst and Young in the Transaction Advisory Services group where he performed valuation, transaction advisory, and dispute resolution services to the firm's corporate and private clients.

Mr. Meindl received a Bachelors of Business Administration from Wake Forest University, and a Masters of Business Administration from Southern Methodist University. Mr. Meindl holds the Chartered Financial Analyst (CFA) designation.