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The Risks and Rewards of Setting Physician Compensation Internally

AT A GLANCE

- To establish physician compensation internally, finance leaders should:
- Educate decision makers on basic regulatory guidance and valuation theory
- Determine fair market value
- Consider using a compensation calculator

A rapid growth in physician alignment strategies has created a surge in physician service agreements.

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To maintain compliance with regulatory guidance from the Centers for Medicare & Medicaid Services (CMS), the Office of Inspector General (OIG), and other authorities, hospital leaders should set physician compensation at fair market value (FMV). *FMV* is defined in the professional literature as “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.”^a

Although some hospitals might consider hiring a third-party firm to determine whether each physician arrangement is at FMV, this approach can be time-consuming and expensive. Fortunately, healthcare executives also have a choice of various other strategies that can streamline this process and, if implemented properly, solidify compliance efforts within the health system.

Compliance Essentials

Health systems should consider taking clear steps to demonstrate a commitment to compliance. The mere existence of a compliance program that outlines how to set physician compensation, for example, can demonstrate the health system’s good-faith intent to comply with the FMV standard. This program should promulgate written protocols and best practices, and it should be effectively communicated throughout the organization, with staff assigned to monitor and, most important, enforce the program.

When physician compensation is set through an inconsistent process throughout a health system, such as via business development initiatives, the arrangement is more likely to be subject to regulatory scrutiny.

The Importance of FMV

Failure to set physician compensation at FMV puts hospital leaders at risk for criminal or civil penalties—or both—based on healthcare fraud and abuse laws. If federal or state authorities audit a professional services agreement between a physician and a healthcare entity, the analytical process and documentation to demonstrate that the payment is at FMV will be essential in defending the compensation.

One challenge for hospital leaders is that the logical methods for determining FMV are not always supportable in the eyes of regulatory authorities. For example, compensating a physician based on what a competing hospital pays does not substantiate a supportable method for establishing FMV. Determination of FMV under healthcare regulations may not always be consistent with generally accepted appraisal standards. In fact, certain departures from standard appraisal practice may be required, as indicated in the interim final rule for Phase II of the Stark law: “Moreover, the definition of ‘fair market value’ in the statute and regulation is qualified in ways that do not necessarily comport with the usage of the term in standard valuation techniques and methodologies.”^b

Specifically, CMS views reliance on certain types of market data in determining FMV as problematic. For instance, in the previously cited interim final rule, CMS indicates that the FMV may not consider the value or volume of referrals and that one should not rely on data produced by referral relationships: “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.”

2 Moreover, in a final rule issued about three years earlier, CMS says, “Depending on the circumstances, the ‘volume or value’ restriction will preclude reliance on comparables that involve entities and health care providers in a position to refer or generate business.”^c

From a compliance perspective, hospital leaders should be able to answer “yes” to two questions: Could I defend and explain the derivation of the compensation paid to the physician for the services provided in a court of law? And, more specifically, has the compensation been established without considering the value or volume of referrals?

These questions constitute an essential step in proving that a hospital or other entity has maintained compliance with its physician compensation arrangements. It also is important to recognize that regulatory authorities hold the health system accountable for unsupported valuations. In other words, even if a third-party valuation firm has been engaged to verify that the compensation is set at FMV, the health system is still at risk if that firm does not supply a credible valuation in the eyes of the regulatory authorities.

Case in point: In *United States ex. rel. Drakeford v. Tuomey Healthcare System, Inc. (2010)*, a case which is still not settled, the government’s expert reviewed the third-party valuation report relied upon by Tuomey Healthcare System. Allegations were that during 2005 and 2006, Tuomey entered into numerous part-time contracts in which physician specialists were compensated above market levels to induce referrals. The government’s expert opined that the methodology and conclusions of the third-party valuation report that the defendants relied upon were not supportable. Therefore, the health system, not the valuation firm, was subject to penalties for the compensation arrangement.

Because of such cases, coupled with the surge in physician alignment strategies, understanding the fundamentals of how to determine FMV has become increasingly important to the healthcare industry. Healthcare executives are faced with the challenge of how to best incorporate FMV into their physician alignment processes.

Key Considerations for Determining FMV

In general, health systems that take a systematic and conservative approach to their physician compensation arrangements tend to produce arrangements that are at low risk of noncompliance with FMV requirements. The risk of noncompliance increases, however, as physician alignment arrangements become more complicated and innovative, and as compensation strategies become more intricate. Bringing in consultants to guide these strategies also can increase a health system's risk of noncompliance if, as a result, the health system's leaders do not remain fully informed and engaged in the process to help ensure the FMV standard is considered during negotiations.

In short, the nuances of determining FMV, coupled with the influence physicians can have on a health system's economic viability, can make these valuations more challenging. Educating business development personnel, compliance officers, legal counsel, and C-level executives on basic, relevant regulatory guidance and valuation theory is an important early step to setting physician compensation internally.

In negotiating physician compensation, finance leaders should keep a number of guiding principles in mind.

A physician's "going rate" does not necessarily constitute FMV. This rate may simply be what the physician believes is reasonable compensation from his or her viewpoint. Such a rate would be extremely difficult to support as a sound valuation methodology if scrutinized.

3 *Historical compensation does not necessarily constitute FMV.* There are myriad factors that should be considered when determining FMV and the justification for compensation. What the physician was paid last year may be understated or overstated from an FMV perspective.

Anticipated referral revenue should not be a factor when determining FMV. In general, considering the technical revenues that could be brought to a hospital as a result of a physician alignment strategy can be problematic. That being said, considering a physician's personal productivity is a reasonable factor in determining compensation.

The FMV of administrative services may differ from the FMV of clinical services. For example, what a physician would earn if he or she was performing surgery versus serving as a medical director does not necessarily constitute FMV. In general, many of the lower-paid specialties (such as primary care) are paid more than median clinical compensation for administrative positions, although many of the higher-paid specialties (such as neurosurgery) are paid less. In short, opportunity costs, or income the physician could be bypassing, should not be relied upon as the sole FMV methodology.

Reliance on a single survey or one approach may not support FMV. Some health systems develop an internal compensation plan that relies solely on one published survey. It is important to note there is regulatory guidance suggesting that multiple, objective surveys should be considered when determining the FMV of physician compensation. But not all data sources are created equal. Surveys for certain services, such as on-call coverage, are considered unreliable because of the referral relationship reflected in the data, the low number of responses, and the lack of details provided regarding the burden of call.

Solutions to Determining FMV

Health systems across the country have different approaches to determining FMV. Similarly, the risk tolerance of health systems varies greatly. Yet most health systems have some sort of internal control for deciding if a third-party valuation opinion is needed. In fact, many utilize the median provided by the

Medical Group Management Association (MGMA) as a benchmark to decide if clinical compensation needs a more detailed review.

Options for maintaining compliance with the FMV standard include the following.

Establish conservative arrangements internally that are clearly consistent with FMV. One drawback to this approach is that it may be difficult to attract physicians who have exceptional reputations or are high producers.

Use a conservative internal benchmark to determine whether to engage a third-party valuation firm. Under this approach, the organization will engage a valuation firm only if compensation falls outside this benchmark (for example, median compensation). However, this approach can be expensive, especially with the rapid growth in aggressive physician-alignment strategies.

Employ a valuation analyst to work for the health system internally. A potential downside is that the valuation may appear to be biased and could be scrutinized because it is not developed by a third party.

Use a compensation calculator. Such calculators are available for purchase from third-party valuation firms and may cover the majority of compensation arrangements. Some calculators are quite complex, incorporating various valuation drivers and reasonability tests, while others simply report data regarding median compensation for a specialty but consider multiple surveys as suggested in the government's Stark Law guidance. (For a more in-depth discussion of compensation calculators, go to hfma.org/hfm.)

4 It should be noted, however, that certain arrangements might require additional analyses. These are not always the arrangements that include high compensation, but rather those with multiple layers of services or those that simply require a more robust approach.

The Bottom Line

With the rapid growth in physician alignment strategies, implementing an efficient and consistent internal methodology for determining physician compensation is essential. However, it is important to understand that determining FMV is only one component of a compliance plan related to physician alignment. Equally important is ensuring that there is a legitimate business need for compensation arrangements and that the contractual terms are reasonable.

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footnotes

a. *The International Glossary of Business Valuation Terms*, jointly developed by the American Institute of CPAs, the American Society of Appraisers, the Canadian Institute of Business Appraisers, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts, [Business Valuation Resources](#), 2001.

b. CMS, "Medicare Program; Physicians' Referrals to Health Care Entities with Which They Have Financial Relationships (Phase II)," *Federal Register*, March 26, 2004.

c. CMS, "Medicare Program; Physicians' Referrals to Health Care Entities with Which They Have Financial Relationships (Phase II)," *Federal Register*, Jan. 4, 2001.

sidebar

Checklist for Entering into a Physician Compensation Arrangement

There is no single way to set compensation, and the solution for each health system may be based on myriad factors. However, the following checklist for decision makers can apply to most situations:

- Verify that the compensation arrangement is commercially reasonable and serves a legitimate business purpose before determining compensation.
- Avoid basing compensation on current or expected referrals.
- Ensure legal counsel has approved the terms of the agreement.
- Understand the services listed in the agreement and the credentials and/or specialty required for the position.
- Follow an established policy to determine FMV for those services and approach the determination of compensation consistently throughout the entire health system.
- If compensation falls outside normal market guidelines, a health system could apply a more robust valuation approach, which could involve obtaining a third-party opinion or analyzing the productivity and profitability of the physician.