Fair Market Value and Commercial Reasonableness Involving Healthcare Transactions and Arrangements

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INTRODUCTION VMG HEALTH

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AGENDA

1. APPLICABLE LAWS AND FAIR MARKET VALUE
2. VALUATION OVERVIEW
3. FMV VALUATIONS GONE WRONG
4. QUESTION & ANSWER
APPLICABLE LAWS & FAIR MARKET VALUE
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.
The healthcare industry is heavily regulated and these regulations help guide the transaction environment.

- Acquisition or arrangement must make commercial sense even if there were no potential DHS referrals.
- Sometimes viewed as a pre-cursor to determining FMV.

- 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**

**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. 411.351)
APPLICABLE LAWS

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)
APPLICABLE LAWS

How do these statutes affect the terms of the transaction?

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

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

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

## 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

<table>
<thead>
<tr>
<th>Normalized Base Year</th>
<th>Projection Period</th>
<th>Terminal Year</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>Revenues:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Net Operating Revenue</td>
<td>5,470,813</td>
<td>5,680,466</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-Compensation earnings</td>
<td>2,460,467</td>
<td>2,389,024</td>
</tr>
<tr>
<td>Provider Compensation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Provider Compensation</td>
<td>2,114,555</td>
<td>2,159,500</td>
</tr>
<tr>
<td>EBITDA</td>
<td>345,943</td>
<td>389,334</td>
</tr>
<tr>
<td>Depreciation &amp; Amortization Expense</td>
<td>12,409</td>
<td>18,469</td>
</tr>
<tr>
<td>Interest Expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal &amp; State Income Tax Expense @ 38.58%</td>
<td>129,657</td>
<td>143,080</td>
</tr>
<tr>
<td>Earnings After Income Taxes</td>
<td>$224,818</td>
<td>$227,785</td>
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</tbody>
</table>

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

\[
\text{Present Value of Cash Flows} = \text{Value Indication}
\]

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VALUATION APPROACHES

INCOME APPROACH CONT.

UNDERLYING ASSUMPTIONS

Volume
Reimbursement
Post Transaction Compensation
Expense Forecast
Capital Expenditures

COST OF CAPITAL

Cost of Equity
Cost of Debt
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

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

#### FAIR MARKET VALUE VS. STRATEGIC / INVESTMENT VALUE

Examples of common valuation considerations include the following:

<table>
<thead>
<tr>
<th><strong>FAIR MARKET VALUE</strong></th>
<th><strong>STRATEGIC / INVESTMENT VALUE</strong></th>
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</thead>
<tbody>
<tr>
<td>✓ ✔ Adjusting reimbursement rates to market participant rates</td>
<td>✗ ✔ Adjusting reimbursement rates to acquirer’s contracted rates</td>
</tr>
<tr>
<td>✓ ✔ Market participant cost savings</td>
<td>✗ ✔ Acquirer specific cost efficiencies</td>
</tr>
<tr>
<td>✓ ✔ Fair market value rent rate</td>
<td>✗ ✔ Related-party rent arrangements</td>
</tr>
<tr>
<td>✓ ✔ Post-Transaction compensation</td>
<td>✗ ✔ Pay for referrals</td>
</tr>
</tbody>
</table>
VALUATION CONSIDERATIONS
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.
FAIR MARKET VALUATIONS GONE WRONG
FAIR MARKET VALUATION 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

  • 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
FAIR MARKET VALUATION GONE WRONG

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.

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.

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.
FAIR MARKET VALUATION GONE WRONG
FIVE KEY TAKEAWAYS FROM RECENT CASE LAW

1 SERVICES MUST BE PROVIDED


✓ 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
FAIR MARKET VALUATION GONE WRONG
FIVE KEY TAKEAWAYS FROM RECENT CASE LAW

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
FAIR MARKET VALUATION GONE WRONG
FIVE KEY TAKEAWAYS FROM RECENT CASE LAW

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
FAIR MARKET VALUATION GONE WRONG

FIVE KEY TAKEAWAYS FROM RECENT CASE LAW

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
FAIR MARKET VALUATION GONE WRONG
FIVE KEY TAKEAWAYS FROM RECENT CASE LAW

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”
# FAIR MARKET VALUATION GONE WRONG

<table>
<thead>
<tr>
<th><strong>DOs</strong></th>
<th><strong>DON’Ts</strong></th>
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<tbody>
<tr>
<td>✓ Must consider all facts and circumstances</td>
<td>✗ Inaccurate assumptions are not okay</td>
</tr>
<tr>
<td>✓ Must ensure calculation accuracy</td>
<td>✗ No opinion shopping</td>
</tr>
<tr>
<td>✓ Periodically reevaluate opinions</td>
<td>✗ Do not consider referral volume or value when determining FMV in healthcare setting</td>
</tr>
<tr>
<td>✓ Valuation should match/align with agreement</td>
<td></td>
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<tr>
<td>✓ Examine economic and operational reasonability of an arrangement</td>
<td></td>
</tr>
<tr>
<td>(commercially reasonable)</td>
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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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Andy Demetriou is a corporate counselor and strategic advisor with deep experience in the health care industry. He conducts a broad ranging corporate practice, devoting substantial time to mergers, acquisitions, corporate governance issues and strategic counseling for companies in many sectors of the economy, including private equity backed buyers and sellers. During his career he has advised developmental stage companies as well as members of the Fortune 50. He has developed expertise in the legal issues affecting the healthcare industry over the past 25 years and has a national reputation as a lawyer in this field. In addition he is called upon by individuals with sophisticated business interests for his legal and practical judgment on investments, charitable activities, succession planning for family enterprises and disputes. Andy is a nationally known author and speaker on topics including legal issues affecting the health care industry, corporate transactions, corporate governance and compliance, legal and business ethics and professional responsibility. In recent years he has made presentations at over 125 conferences sponsored by organizations such as the American Bar Association, American Health Lawyers Association, California Continuing Education of the Bar, the Colorado Bar Association, the New Mexico State Bar, the State Bar of Texas, the Los Angeles County Bar Association, Practising Law Institute, and the California Society of Association Executives. His legal writings have appeared in publications of the American Bar Association, American Health Lawyers Association, the Bureau of National Affairs (now Bloomberg Legal), American Lawyer Media, and the Los Angeles County Bar. He contributed (with William W. Horton) a chapter on The Role of Directors in Corporate Compliance published in the Annual Health Law and Compliance Update (Aspen 2015).
Mr. Brewster is the founding partner of Brewster Law Firm LLC, a boutique healthcare practice formed in 2011. His experience includes the representation of healthcare systems, providers and healthcare technology companies. He has represented clients in transactional and litigation matters, anti-kickback compliance, FMV compliance, Medicare audits and FCA matters. He has experience in complex joint venture disputes and dialysis related matters.

Previously, Mr. Brewster served in in-house roles at Allscripts and the U.S. subsidiaries of BrainLab and Optasia Medical. His law firm experience includes associate positions at McGuireWoods and Weil Gotshal & Manges. Mr. Brewster is a graduate of Boston College Law School and Syracuse University (summa cum laude). He is licensed to practice law in Illinois and Massachusetts.

Mr. Brewster is active in the ABA Health Law Section serving as a Vice Chair and Chair of the Life Science committee (2011-16) and as a Vice Chair on the Membership (2013-17), Sponsorship (2014-17), and Ethics & Professionalism (2017-current) committees and on the ABA Taskforce for Substance Abuse Disorders Advisory Board (2016-current). He has served on the Editorial Advisory Board of the FDLI’s Food and Drug Law Journal (2012-15) and Global Committee (2015-17). He is a Fellow of the American Bar Foundation.
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