A Compliance Officer’s Approach to Fair Market Value Analyses: Practical Advice and Dilemmas

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<th>Name</th>
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Agenda

- Background of Fair Market Value
- Engaging a valuator
- Transaction elements:
  - Physician Compensation
  - Business Valuation
  - Overall Transaction and Commercial Reasonableness
- Utilizing the Valuation Report
- Role of The Compliance Officer in the Valuation
FMV 101: Healthcare Arrangements & Transactions

Generally, any transaction between potential referral sources must be:

i. consistent with FMV; and

ii. commercially reasonable.

A transaction can be “FMV,” but not commercially reasonable, and vice versa.

Healthcare regulations impose specific guidance that directly impact FMV analysis:

- Avoid tainted market values
- Avoid improper valuation methodologies
Transactions your organizations may enter where FMV plays a role

1. Employment
2. Recruitment and Retention Assistance
3. Office Space Arrangements
4. Practice acquisitions
5. Call coverage
6. Medical Directorships
7. Management Contracts
8. Joint Ventures
9. Quality Integration Arrangements (clinical co-management, P4P/P4Q models)
10. Gainsharing
11. Payor Contracting Strategies
12. Participating Bond Transactions
13. Physician Hospital Organization (PHO)
14. Captive Insurance Arrangements
“The general rule of thumb is that any remuneration flowing between hospitals and physicians should be at fair market value for actual and necessary items furnished or services rendered based upon an arm’s-length transaction and should not take into account, directly or indirectly, the value or volume of any past or future referrals or other business generated between the parties.”

OIG’s Supplemental Compliance Guidance for Hospitals (January 31, 2005)
“Arrangements under which hospitals (i) provide physicians with items or services for free or less than fair market value, (ii) relieve physicians of financial obligations they would otherwise incur, or (iii) inflate compensation paid to physicians for items or services pose significant risk. In such circumstances, an inference arises that the remuneration may be in exchange for generating business.”

OIG’s Supplemental Compliance Guidance for Hospitals (January 31, 2005)
FMV factors into enforcement decisions in meaningful way . . .

_U.S. vs. Bradford Regional Medical Center, et al., Civil Action No. 04-186 Erie (WD PA, Nov. 10, 2010)_

- Payment for non-compete from hospital to cardiology group in connection with sublease to hospital of nuclear medicine camera was found to violate Stark Law, notwithstanding fixed fee and independent appraisal of FMV
- Appraisal based on expected revenues from cardiology referrals in the absence of an interest in their own cardiac imaging service--takes into account volume/value of anticipated referrals from cardiology group
What is FMV?
Well, why do I care?

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<tr>
<th>Stark Law</th>
<th>AntiKickback Statute (AKS)</th>
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<td>Violations may result in substantial civil monetary penalties and/or exclusion from participation in Medicare. Avoiding violations usually requires meeting an “exception.” Most Stark Law exceptions include the requirement that payments are fair market value.</td>
<td>Violations may result in criminal prosecution, substantial civil monetary penalties, and/or exclusion from participation in federal healthcare programs, including Medicare; Avoiding violations is best accomplished by meeting a “safe harbor.” Most AKS “safe harbors” include the requirement that payments are fair market value.</td>
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<th>The False Claims Act</th>
<th>IRS Code for 501(c)(3) entities</th>
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<td>Prohibits the knowing submission of false or fraudulent claims for payment to the Federal government; creates mechanism for <em>qui tam</em> actions; violations of Stark and Antikickback may give rise to actions under the false claims act.</td>
<td>Payments in excess of fair market value may violate prohibition on private inurement/excess benefit and result in intermediate sanctions and/or jeopardize tax exemption.</td>
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What is FMV?

International Glossary of Business Valuation Terms (aka the “guidebook” for valuation professionals - healthcare and non-healthcare) provides this definition:

*FMV is the price, expressed in terms of cash equivalents, at which 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 or sell and when both have reasonable knowledge of the relevant facts.*
What is FMV?

Stark Law provides this definition:

*The term “fair market value” means the value in arm’s length transactions, consistent with the general market value... (42 USC § 1395nn)*

42 CFR §411.351 – “general market value” means the price that an asset would bring or that would be included in a service agreement as a 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

Stark Phase I Preamble – FMV is established by a reasonable method that provides evidence that compensation is comparable to that paid for comparable items or services in the marketplace in arm’s length transactions by parties not in a position to refer to one another
What is FMV?

AKS does not provide an explicit definition of FMV, but many OIG publications are informative of how the government may informally define FMV for AKS purposes.

AKS guidance suggests a similar definition of FMV to the Stark definition – *i.e.*, fair market value is the value in arm’s length transactions, when there is no tainting by the potential of the parties to the transaction to generate referrals or other business for each other.
What is FMV?

Government commentary, advisory opinions and case law suggest that FMV (for purposes of complying with Medicare fraud and abuse laws) is probably **not**:

- The amount that results from earnest negotiations (earnest is not necessarily “arm’s length” when there are potential business referrals in play)

- The amount that a specific physician “normally charges” for services

- Opportunity cost

- What a physician or hospital received for similar services provided to a competitor last year (unless the physician was not practicing nor planning a return to practice last year, such that there was no tainting of the relationship with the competitor by the opportunity for potential physician referrals)
What is FMV?

Government commentary, advisory opinions and case law suggest that FMV (for purposes of complying with Medicare fraud and abuse laws) may be/probably is:

- A value or range of values that results from commonly accepted valuation principles and/or from otherwise reasonable processes and data that establish what compensation *would* be in a transaction that is similar, but in which parties are not in a position to refer or otherwise generate additional business for each other.

- A hypothetical concept (not necessarily what specific parties to a specific transaction think that the subject items or services are worth).
What is FMV?

Government commentary and case law suggest that, with respect to service agreements, FMV may be influenced by the following factors:

- Subject matter expertise/specialty of the individual performing the services
- Education and training that are reasonably required to perform the services (Do the services require a neurosurgeon, or will a primary care physician suffice?)
- The prevailing rate for comparable types of professionals performing comparable services (being mindful to avoid “tainted” values)
- The nature and complexity of the services provided
- If the services are needed and provided in a specific geographic market, the unique aspects of that market such as cost of living, shortage of individuals entities that are qualified to provide the services, etc.
Engaging a Valuator

Do you need to hire an outside valuation firm to determine FMV?

The Pros of hiring an outside valuation firm:

- Outside valuator/valuation firm is independent = the government is assured that the selection and interpretation of data is not biased by the interests of stakeholders

- A reputable and experienced outside valuator/valuation firm is likely to use widely accepted valuation principles = defensible, reproducible results

- Reputable outside valuator/valuation firm is expected to have more extensive knowledge of valuation principles, more experience applying valuation principles, and better access to data than internal personnel in healthcare organizations
Engaging a Valuator

Do you need to hire an outside valuation firm to determine FMV?

The Pros of hiring an outside valuation firm (cont.):

- Despite upfront cost, using an outside valuation firm can save $$$ in the long term, especially with higher value arrangements that are likely to attract scrutiny.

- Outside valuator involvement may help to manage/avoid unrealistic expectations; Valuators can often spot issues and help parties arrive at workable deal terms (particularly if engaged early in negotiations).

- Outside valuation firm has knowledge and expertise that may assist in objective evaluation of commercial reasonableness.
Engaging a Valuator

Do you need to hire an outside valuation firm to determine FMV?

Experienced healthcare valuation firms will assess and or render opinions regarding commercial reasonableness

An important consideration because several Stark Law exceptions require not only that the arrangement be FMV, but also that it be “commercially reasonable” (office space rental exception, employment exception, equipment rental exception, isolated transactions exception, group practice exception, indirect compensation exception)

Some argue that FMV and commercial reasonableness are so interrelated that one cannot be determined without consideration of the other

Examples of when this would be the case:

- Compensation stacking scenarios
- Severance obligations and/or full-time benefits offered in part-time employment arrangements
Engaging a Valuator

Do you need to hire an outside valuation firm to determine FMV?

The Cons of hiring an outside valuation firm:

- Cost (Fees)
- Cost may be more than benefit (especially for low $ arrangements that are unlikely to attract scrutiny)
- Generally, an outside valuator/valuation firm is not “necessary” to establish FMV

“We have hundreds of arrangements and every one is unique” = can’t afford to hire someone to look at every single one

- 3rd party valuation opinion is not a guarantee against legal scrutiny or even against liability (despite the cost)
- Timing – may take longer to get results from an outside valuator/valuation firm than an internal process
How to Engage a Valuator

Needs to be under Privilege? If yes:
- Typical engagement is by Purchaser
- Joint Engagement may be utilized if a Joint Defense agreement is in place.

No Privilege is needed:
- Purchaser (Frequently)
- Joint Engagement (Occasionally)
- Seller (Rarely)

Expense responsibility, confidentiality, trust and the relationship between the parties are important elements of the decision.
# How to Engage a Valuator

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<tr>
<th>Scenario</th>
<th>Advantages</th>
<th>Challenges</th>
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| 1. One Party hires an appraiser to provide the opinion (Limited Transparency) | a) Greater Negotiation Flexibility for the hiring party                    | a) Potential perception of valuator as non-independent.  
b) Sharing of valuation information may be limited.                                              |
|                                                                        |                                                                           | a) May require more precision  
b) Generally takes more time and is more difficult to manage for valuator.  
c) Higher potential cost |                                                                                                       |
| 2. Both Parties jointly engage an appraiser to provide the opinion (Transparent between Parties) | a) Open sharing of information Analysis                                     |                                                                                        |
|                                                                        |                                                                           |                                                                                                       |
| 3. Both Parties jointly engage an appraiser to provide the opinion and one party hires a valuation consultant | a) The party who hires the valuation consultant may have an advocate        | a) Can lead to difficulties depending upon the “role” and expertise of the valuation consultant  
b) Higher total cost |                                                                                                       |
|                                                                        |                                                                           |                                                                                                       |
| 4. Both Parties hire their own appraisers                                | a) Both Parties have their own valuation consultant                       | a) Higher total Cost  
b) Potential for appraiser disagreements based upon different data or methodology |                                                                                                       |
Role of Valuation Consultant

Legal counsel typically does not provide a legal opinion as to the FMV or commercial reasonableness of a compensation arrangement.

Legal counsel will most likely obtain an independent valuation consultant to provide a certified valuation opinion as to the FMV and/or commercial reasonableness of a compensation arrangement.

Courts have found thorough valuations of both lease and compensation arrangements as persuasive evidence of FMV as against a less thorough valuation of a government expert witness.

Transaction Elements

- Physician Compensation
  - Clinical
  - Call Coverage
  - Administrative
- Professional Practice
- Ancillaries
- Overall Transaction
The Importance of “Understandability...and Legality” in Physician Compensation Plans
Red Flags Developing Physician Compensation Plans Arrangements

- You told them you would pay them what they are making in their practice today.
- I’ve never seen a compensation plan quite like that one.
- Wow, that proposed compensation is off the charts, I sure hope the doctor’s production is, too.
- Hmmm, we might have to get creative with our analysis to fit that quality compensation into a FMV range.
- We did that back in the 1990s and can do it again.
- Sure, I can give a commercial reasonableness opinion, too, it’s the same as FMV.
- So, you want to pay $2000/day for call coverage because that is what the doctors said their colleagues made in another state.
- Well, it doesn’t really matter, all compensation is the same.
- You want to pay the same recruitment stipend to a Fellow and to a Resident.
- You don’t know what to pay the local FP you hired to help you plan your cancer COE.
Caveat Re: “All-in” Clinical Compensation Assessments

Although there will be an “All-In” FMV Assessment for most of the Compensation paid for Clinical activities; Medical Administrative Compensation is “earned” separately and requires separate FMV analyses.

Our FMV Tests typically evaluate the reasonableness of Clinical Compensation (including Base Salary, Production Incentives, and Qualitative/Service incentives) to varying benchmarks, including: (1) per FTE; (2) per Professional Collections; and (3) per WRVU production.

Med. Admin. stipends may be evaluated per Clinical Comp/Hour and Physician Executive Comp. benchmarks.

Ongoing assessments re: reported physician services “within the benchmarks”
Implications Regarding Valuing Physician Services

Multiple Factors May Justify Utilization of “Higher” Ends of a FMV Range. However, the rationale should be consistently applied and documented.

Example: Potential Justifiable Compensation Ranges

Valuation Development; then Management Flexibility re: Placements within “the Range”
Evolving “Correlation” Tests to Assess the Reasonableness Of Physician Compensation to Production Levels

Increasing importance of non-productivity behaviors are requiring revision of prior “correlation tests”

- Production Performance
- Quality / Service Performance

P50

P75

P90+

<=5% - 10% “Correlation”

<=15% “Correlation”

20-25% “Correlation”

Movement to recognize further “stretch goals” for quality, service and efficiency – without as much reliance upon volume and/or panel size, etc.
### Valuation Methods and Key Considerations in Business Valuations

**Income Approach** - Based on discounted cash flows, or capitalized cash flows

- Reliability of Management Projections
- Historical/Industry Trends
- Go-forward arrangements
- Future Outlook
- Regulatory Outlook
- Discount Rate

**Asset Approach** - Based on the underlying identified assets

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<th>Key Tangible Assets:</th>
<th>Liabilities:</th>
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<tr>
<td>Working Capital</td>
<td>Current Liabilities</td>
</tr>
<tr>
<td>Furniture, Fixtures &amp; equipment</td>
<td>Accrued PTO for Employees</td>
</tr>
<tr>
<td>EMR Systems</td>
<td>Interest bearing debt</td>
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**Potential Key Intangible Assets:**

- Trade Name
- Covenant not to Compete
- Payor Contracts
- Certificate of Need
- Trained & Assembled Workforce

- Capital leases

**Market Approach** - Based on sales of other similar companies

- Comparable Transaction Method
- Comparable Company Method
Importance of Physician Compensation in Business Valuation

Physician Compensation Expense Allocation

- Compensation paid for physician clinical, on-call, and administrative services is distinct from reimbursement by a third-party payor for physician clinical services performed.

- Compensation is an economic expense burden allocated against the revenue stream generated from the professional physician services performed by the employed physicians.

- Economic expenses burden related to the physician’s malpractice insurance expense burden must be properly allocated and accounted for in determining FMV and commercial reasonableness of proposed physician compensation transactional arrangements.
Establishing FMV & CR

OIG Compliance Program Guidelines

- Effective compliance program may help avoid potential violation of Stark Law, Anti-Kickback Statute, and Federal False Claims Act
- Build on-going compliance into the agreements, e.g., periodically assess FMV and periodically audit compliance with duties required by the agreement.
- These seven components provide a solid basis for a voluntary compliance program:
  1. Conducting internal monitoring and auditing
  2. Implementing compliance and practice standards
  3. Designating a compliance officer
  4. Conducting appropriate training and education
  5. Responding appropriately to detected offenses and developing corrective action
  6. Developing open lines of communication
  7. Enforcing disciplinary standards through well-publicized guidelines
Commercial Reasonableness

In 1998, the Center for Medicare Services ("CMS"), in its Stark proposed rule, clarified “commercially reasonable” to mean that an arrangement appears to be a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals."³ In the preamble to the Stark Phase II interim final rule, CMS further stated that "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 designated health services ("DHS") referrals."⁴

Commercial Reasonableness (CR)

Determining Commercial Reasonableness
IRS’ Determination of Commercial Reasonableness

Factors the IRS considers when determining the commercial reasonableness of a physician compensation arrangement:

- Specialized training and experience of the physician
- The nature of duties performed and the amount of responsibility
- Time spent performing duties
- Size of the organization
- The physician’s contribution to profits

Commercial Reasonableness (CR)

Determining Commercial Reasonableness

IRS’ Determination of Commercial Reasonableness

Factors the IRS considers when determining the commercial reasonableness of a physician compensation arrangement (cont.)

- National and local economic conditions
- Time of year when compensation is determined
- Whether the compensation is in part or in whole payment for a business or assets
- Salary ranges for equivalent physicians in comparable organizations
- Independence of the board or committee that determines physician compensation arrangement

Commercial Reasonableness (CR)

- Determining Commercial Reasonableness
- Violations of FMV & CR Under Stark and Anti-Kickback

Increasing scrutiny of compensation arrangements courts will focus on whether physicians are actually performing the services outlined in the arrangement.

If a physician is not performing services which are required within the scope of the compensation agreement, the arrangement will not meet the threshold of commercial reasonableness.

Commercial Reasonableness (CR)

Determining Commercial Reasonableness

Violations of FMV & CR Under Stark and Anti-Kickback

Increasing scrutiny of compensation arrangements → courts will focus on whether physicians are actually performing the services outlined in the arrangement

If a physician is not performing services which are required within the scope of the compensation agreement, the arrangement will not meet the threshold of commercial reasonableness.

How to read, understand and interpret a valuation report

Expected Elements of a Valuation Report:

- Description of the valuation assignment
- The definition of value on which the valuator relied
  - FMV, strategic value, fair value, etc.
  - If FMV, is it the Stark definition of FMV?
- Inputs and assumptions on which the valuator relied:
  - Description of the facts and circumstances provide context for the valuation
  - Description of the service agreement or enterprise that is the subject of the valuation
  - “Governing Assumptions”
How to read, understand and interpret a valuation report

**Expected Elements of a Valuation Report (cont.):**

- Explanation of valuation approaches considered and used
  - Market Approach
  - Cost Approach
  - Income Approach
- Description of market data considered and used
  - Sources
  - Values
How to read, understand and interpret a valuation report

**Expected Elements of a Valuation Report (cont.):**

- Effective period/expiration date of valuation report
- Limiting conditions on appraisers analysis and/or conclusions
- Statement of valuator’s conclusions
  - FMV range; and/or
  - Statement that a proposed amount is consistent with FMV; and/or
  - Statement of commercial reasonableness of the arrangement
How to read, understand and interpret a valuation report

Flags:

- Mismatch between facts, circumstances or agreement terms as described in the report and as understood by the stakeholders
- “Governing Assumptions” that are untrue, incorrect or otherwise inconsistent with reality
- Limiting conditions that negate the usefulness of the report for supporting the planned agreement or transaction
- Definition of value or valuation approach that is inconsistent with the definition of FMV that is set forth in the Stark Law (e.g., allowing for “tainted” values)
- Language that suggests that an arrangement is not commercially reasonable
- Any other report elements that suggest that reliance on the report would not be reasonably defensible
The Role of the Compliance Officer in Valuation? (Panel Discussion)