

# *Issues Impacting FMV in Complex Healthcare Arrangements*

Sponsored by *Hospital and Health Systems Practice Group*  
December 5, 2007 · 1:00-2:30 pm Eastern

What counsel should be alert to during the valuation process.

## Speaker(s):

Fred M. Lara, HealthCare Appraisers, Delray Beach, FL, [flara@hcfmv.com](mailto:flara@hcfmv.com)  
Jill H. Gordon, Davis Wright Tremaine LLP, Los Angeles, CA, [jillgordon@dwt.com](mailto:jillgordon@dwt.com)  
Greg Endicott, Sinaiko Healthcare Consulting, Inc., Los Angeles, CA,  
[greg.endicott@sinaikohc.com](mailto:greg.endicott@sinaikohc.com)

# Presentation Overview

- Introduction (**BARRY**)
- Approaches to Value (**FRED w GREG**)
- Commercial Reasonableness (**FRED w JILL**)
- Healthcare Valuation Considerations **FRED/GREG w Jill**
- Examples
  - Medical Directorship (**GREG**)
  - Employment (**GREG**)
  - Management (**FRED**)
  - Lithotripsy (**FRED**)
- Conclusions (**FRED/GREG/JILL**)
- Q&A

## Commonly Recognized Valuation Approaches

- Income Approach
  - Cost Approach
  - Market Approach
- 
- All have a business valuation orientation, and all are potentially impacted by their application to healthcare service arrangements

## Use of an Income Approach

- The Income Approach is defined according to the International Glossary as “a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.”
- Components Include - Projections, Discount Rates  
Discounted Cash Flow

## Issues - Income Approach

- There may not be an identifiable income stream.
  - With many arrangements, no specific reimbursement (or profit) can be identified at the hospital level (*i.e.*, the service is reimbursed through DRGs, so the reimbursement attributable to, for example, perfusion or anatomic pathology technical fees is indeterminate.
- Even if an income stream can be identified, there may be no nexus between the income stream and the subject services being valued.
- Discounting/capitalizing a cash flow stream may value, or appear to include, the value of referrals.

## Use of a Market Approach

- This approach is defined according to the International Glossary as “a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.” Similar to a Cost Approach, a Market Approach is based upon the Principle of Substitution.
- Just like selling your house ...in a better market

## Issues - Market Approach

- Even seemingly routine arrangements are impacted by factors not readily apparent to non-valuators, (e.g., professional read arrangements)
- Market values may themselves be in excess of FMV.
  - “Unsophisticated” deals
  - Values may be “tainted” by consideration of referrals
  - Non “arms-length” transactions
- Comparability can be difficult

## Use of a Cost Approach

- The Cost Approach is defined according to the International Glossary as “a general way of determining a value indication of an individual asset by quantifying the amount of money required to replace the future service capability of that asset.” The Cost Approach is based upon the Principle of Substitution; i.e., the premise that a prudent individual will pay no more for a property than he/she would pay to acquire a substitute property with the same utility. The use of a cost approach allows specific analysis of the subject arrangement by considering its specific elements (e.g., the provision of space, equipment, staff, management, and/or supplies)
- If the services is comparable to other services in the marketplace, a market “profit margin” can be identified.
- If the service is too unique, each individual aspect of the services can be segregated and values based upon specific “profit margins.”

## Issues – Cost Approach

- Usage of hypothetical or actual costs
- Hidden costs and hard to quantify items
- Applicable profit margins
  - The market profit margins chosen for each element of the services (e.g., staff, equipment) are not additive.
- The results of a cost approach should be tested for reasonableness. For example, consideration should be given to the relative split of profits among the parties, if applicable.

## Commercial Reasonableness

- The term “commercially reasonable” is defined as an arrangement that would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician of similar scope and specialty, even if there were no potential business referrals between the parties.

# Healthcare Valuation Considerations

- Take a step back
- Beware the Market Approach
- Follow the risk

## Healthcare Valuation Considerations: Take a step back

- Agreement Basics: Who, what, where, when, how and.....why?
- Is it exactly like something else I just did, or just similar?
- Commercial Reasonableness
  - Determining the FMV of a goofy arrangement is pointless.
  - Beware of the disguised “subsidy”
  - Examples of service/management arrangements that may not be commercially reasonable:
    - Outsourcing an existing hospital service
    - Management by multiple physician parties (i.e., without management time/expertise)
    - Part-time/episodic service/management agreement where contracting party has ability to perform services itself

## Healthcare Valuation Considerations: Take a step back

- Commercial Reasonableness - consider a “cross walk” to non-healthcare situations.
  - Although many healthcare arrangements are too unique to allow direct non-healthcare comparisons, at least certain aspects of the arrangement can be considered in a non-healthcare environment.
  - If the arrangement would not likely be reasonable in a non-healthcare setting, the valuator and counsel should exercise particular diligence.
  - Hospitals are privileged with the sole ability to perform and bill for certain services. This privilege should not be unreasonably compromised through a management or service arrangement.

## Healthcare Valuation Consideration: Beware the Market Approach

- For many arrangements, finding values is hard
  - Unique arrangement
  - Not unique but data not available
  - Arms length (and the long arm of the law)
- Determining comparability may be harder
  - Limited visibility on underlying fact pattern
- Use market values cautiously when setting initial expectations

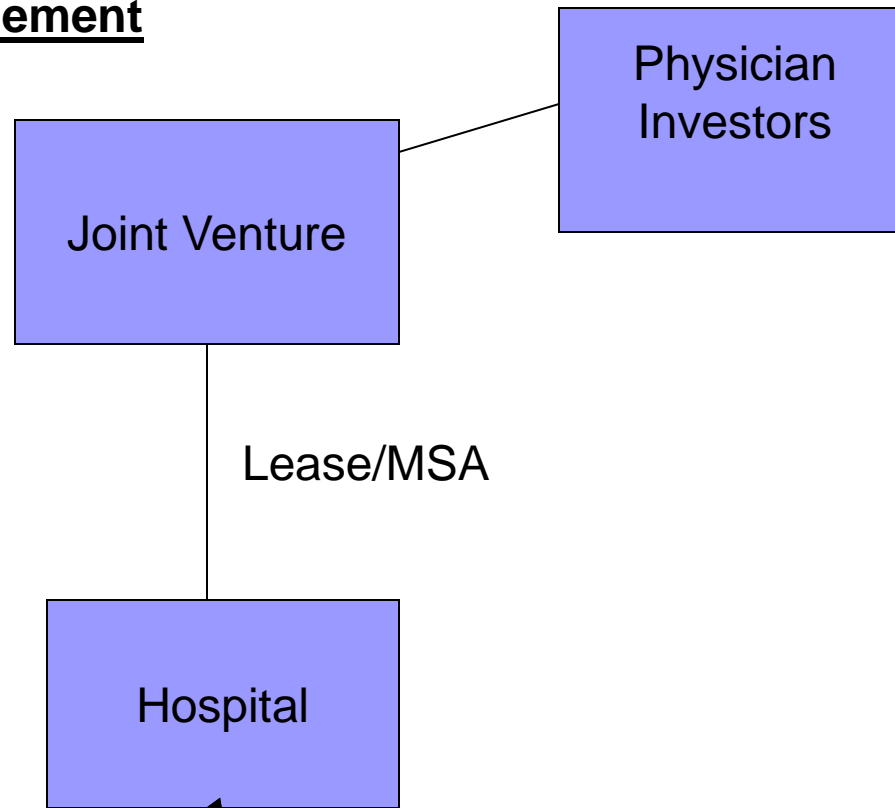
## Healthcare Valuation Consideration: Follow the Risk

- Deep Throat says “Follow the money.”
- In healthcare service/management transactions, “Follow the risk.”
- With return, should go risk
- How the underlying entity providing services is structured can inform a valuation. Examples – from Simple to Complex

# Follow the Risk: Joint Ventures 101

## Equipment Leasing/Management

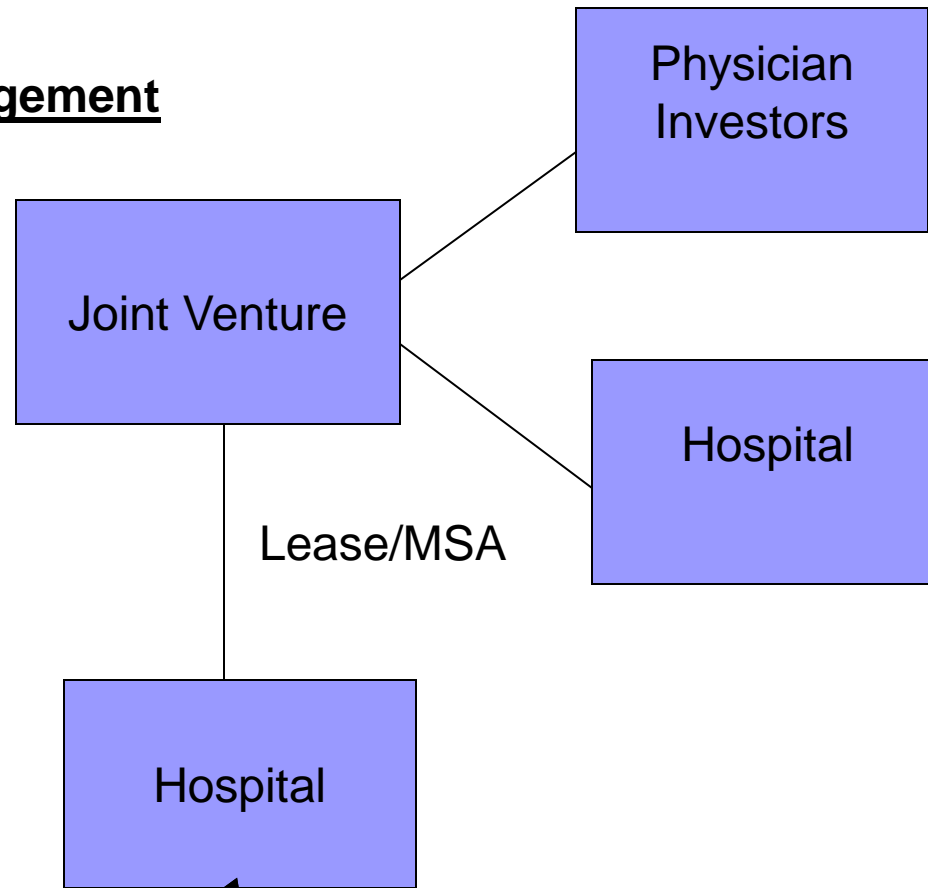
- multiple physicians have ownership interest in jv entity
- jv entity leases equipment to hospital for fmv payment
- physician owners have ability to refer patients to hospital



# Follow the Risk: Joint Ventures 201

## Equipment Leasing/Management

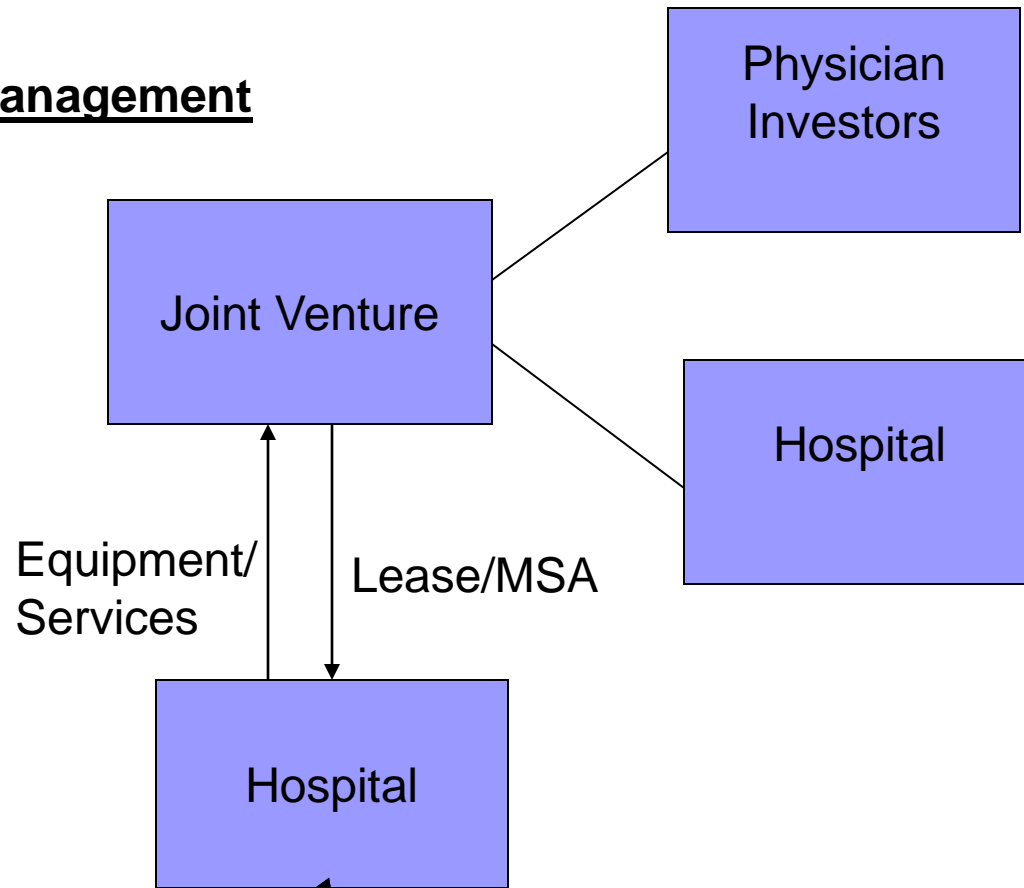
- hospital & multiple physicians have ownership interest in jv entity
- jv entity leases equipment to hospital for fmv payment
- physician owners have ability to refer patients to hospital



# Follow the Risk: Joint Ventures 301

## Equipment Leasing/Management

- hospital & multiple physicians have ownership interest in jv entity
- hospital provides equipment/services to jv
- jv entity leases equipment to hospital for fmv payment (“per-click”?)
- physician owners have ability to refer patients to hospital



## Healthcare Valuation Consideration: Tests of Reasonableness

### ■ Rate of Return -

- In many arrangements, the deployment of tangible assets may be nominal. In such cases, effective rates of return will be extremely high, and therefore not meaningful.
  
- If a rate of return is meaningful, one should consider “return on equity” as well as “return on invested capital” to account for leverage.

## Healthcare Valuation Consideration: Tests of Reasonableness

### ■ Effective Hourly Rates-

- Although many arrangements are not hourly based, consideration should be given to the effective hourly rates of compensation based upon ranges of expected time commitment and ranges of expected compensation

## Healthcare Valuation Consideration: A Service Agreement or a JV?

- Many healthcare services agreements are spawned out of the parties' inability to enter into a JV. Therefore, it is paramount that the management arrangement be analyzed within the "four corners" of the agreement.
- Legal counsel and the valuator should coordinate to understand and define the scope of the parties' relationship, as well as to identify the appropriate scope for the valuation analysis and description to be contained in the report.

## Healthcare Valuation Consideration: Payments for Value and Performance

- Attorneys and valuers may take comfort in “hourly” compensation arrangements for physicians.
- In considering the “cross walk” to non-healthcare scenarios, many examples exist of “value” and “performance” pricing. For example-
  - A research study may be sold over and over, and the profits may far exceed any assessment of “reasonable hourly compensation.”
  - A general contractor may be paid a substantial sum for early completion of a construction project.

## Healthcare Valuation Consideration: Payments for Value and Performance

### ■ Possible healthcare scenarios -

- A physician has developed particular expertise in organizing and managing bariatric surgery programs. Can that physician be paid for his/her *expertise* in establishing a program at a new hospital?
- A physician has developed a set of disease management protocols. Can the protocols be sold to multiple hospitals?
- A hospital service line management arrangement with physicians includes important operations and outcomes metrics. To what extent can physicians be compensated for achievement of these performance metrics?

## Reasonable Compensation

- Result of arm's length bargaining
- Comparable to payment arrangements adopted by other medical groups of similar size and composition in the same geographic area
- For areas not captured by survey: Comparable to payment arrangements in same state for communities similar in size and demographics
- Reasonableness/necessity of requested services

## Valuation Issues

- Identifying true nature of services being performed
- Necessity of services being performed
- Qualifications necessary (Super-adequacy?)
- Are the “sum of parts” reasonable?
- Sources and applicability of market data
- Reasonableness/necessity of requested services

## Physician Compensation

- Primarily utilizes the market approach to valuation supplemented with a cost approach in some cases.
- Physician compensation may consist of a clinical portion and an administrative (medical director) portion, which are generally valued separately
- Review term sheet and/or physician employment agreement to determine physician's time commitment to clinical and administrative duties

## Administrative Versus Clinical Compensation

- CMS raises the question in Phase III whether or not there should be a difference, but leaves the question unanswered
- Clinical vs. administrative compensation
  - Phase III: “...the fair market value of administrative services may differ from the fair market value of clinical services.”
  - No guidance on how to determine FMV if administrative services

## Clinical Compensation

- Collect relevant data for each specialty and type of work
- Make adjustments, as appropriate
- Review historical/expected productivity as measured by collections and/or Work Relative Value Units (wRVUs)
- Consider other relevant market factors
- If new physician and new practice, conduct a proforma of expected professional fee collections and/or wRVUs.
- Does compensation fall within the same benchmark ranges as the production?
- Conduct review of any benefits and physician CV

# Administrative Compensation Considerations

- Stark III removed “Safe Harbor” which included use of certain survey data. Surveys still used; adjustment factors applied where appropriate
- Is there risk of underpayment to physician? Does it suffice for payment to not exceed FMV or is it necessary to be within range of FMV?
- If clinical compensation for a new physician must be equated to productivity, how should productivity be projected?
- If administrative compensation levels exceed median level reported in surveys, the following issues may be considered:
  - High demand, high salaries for specific specialty
  - Unique skills, accomplishments, or status that would bring additional value and justify higher compensation
  - High clinical productivity

## Physician Compensation Considerations in Practice Acquisitions

- Compensation based on physician's own work
- Typically involves review of RVUs historically generated by subject physician
- Should consider what another qualified physician would earn for similar productivity

## Physician Compensation Considerations in Practice Acquisitions (cont'd)

- Group practices are permitted to pay a physician profit shares and productivity bonuses based on services performed personally or “incident to” (includes services and supplies)
  - Compensation cannot be not based on or related to the volume or value of the physician’s referrals.
- In accordance with Medicare coverage and payment regulations, “incident to” services and supplies exclude services and supplies that have their own separate statutory benefit categories such as diagnostic tests.
  - These services may not be billed as “incident to” services
  - A group practice physician may not receive a productivity bonus if the bonus is calculated based on such diagnostic tests, unless the physician personally performed the tests.

# Example – Management Services

<b>Scenario #1</b>	<b>Scenario #2</b>
<p><b>Key Facts:</b></p> <ul style="list-style-type: none"> <li>• None of the Management Company's owners are referring physicians</li> <li>• Resources dedicated include: physician time, employed staff, dedicated office space, office expenses</li> <li>• Agreement is one of many that the Management Company maintains with healthcare facilities in the region</li> <li>• Payment is structured as a flat fee and is consistent with</li> <li>• ASC generates \$3 million in Net Revenue</li> </ul>	<p><b>Key Facts:</b></p> <ul style="list-style-type: none"> <li>• Management Company is completely comprised of referring physicians</li> <li>• Resources dedicated include: Physician's nights and weekends</li> <li>• Agreement is the only such set of services provided by Management Company</li> <li>• Physician is seeking % of Net Revenue structure without a cap</li> <li>• HOPD generates \$10 million in Net Revenue</li> </ul>
<p><b>Cost Approach:</b> Quantifiable dedicated resources are identified and summarized by Management Company's staff.</p>	<p><b>Cost Approach:</b> It is determined that the predominant resource dedicated is the physician's after hours time</p>
<p><b>Market Approach:</b> Comparing to other market arrangements indicates that services are substantially similar</p>	<p><b>Market Approach:</b> Comparing to other market arrangements indicates that services provided here are substantially less than those provided</p>
<p><b>Valuation Conclusion:</b> Market Approach is applicable yielding a valuation conclusion comparable to proposed compensation</p>	<p><b>Valuation Conclusion:</b> Cost Approach is applicable in consideration of the vast difference of resources included with the comparables.</p>

## Example – Management Services

### ■ Management Services

- Valuation impacted by party providing services
- Valuation impacted by cost to party providing services
- Valuation impacted by comparability of services and the context of the comparable values
- Valuation impacted by the size of the agreement

I may need to reformat the structure of the previous slide to move onto about 5 slides for legibility (Facts/Approaches/Conclusion), but this should give a general framework.

# Example – Lithotripsy

Scenario #1	Scenario #2
<p><b>Key Facts:</b></p> <ul style="list-style-type: none"> <li>• None of the Lithotripsy Company's owners are referring physicians</li> <li>• Resources dedicated include: equipment, employed staff, delivery van, storage space</li> <li>• Agreement is one of many that the Lithotripsy Company maintains with healthcare facilities in the multiple regions</li> <li>• Payment is structured as per click fee that declines based on the number of clicks per day</li> <li>• Historical volume is 50 Procedures per year</li> </ul> <p><b>Income Approach:</b> Not applicable due to referrals, but it is a win/win</p> <p><b>Cost Approach:</b> Quantifiable dedicated resources are identified and summarized by Lithotripsy Company's staff. Equipment quote is provided by Lithotripsy Company</p> <p><b>Market Approach:</b> After eliminating physician provider comparables and considering the specific procedure volume, it is determined that there are identifiable comparables available. This includes quotes obtained by the Hospital client from independent providers</p> <p><b>Valuation Conclusion:</b> Market Approach is applicable yielding a valuation conclusion comparable to proposed compensation.</p>	<p><b>Key Facts:</b></p> <ul style="list-style-type: none"> <li>• Lithotripsy Company is completely comprised of referring physicians</li> <li>• Services are not exclusive, other physician owned entities provide these services to Hospital</li> <li>• Resources dedicated include: equipment only, which is stored on site and leased on a per usage basis from the manufacturer</li> <li>• Agreement is the only such set of services provided by Lithotripsy Company</li> <li>• Payment is structured as a per click fee plus additional fees for Bilateral procedures, Cystoscopies, and No Shows</li> <li>• Historical volume is 350 procedures per year</li> </ul> <p><b>Income Approach:</b> Not applicable due to referrals, but it is a win/win</p> <p><b>Cost Approach:</b> Equipment quote provided by Lithotripsy Company</p> <p><b>Market Approach:</b> After eliminating physician providers, it is determined that there are no comparable arrangements</p> <p><b>Valuation Conclusion:</b> Cost Approach is applicable in consideration of the significant procedure volume. Rate structure may need to be altered to a flat rate or a per click with a cap.</p>

## Example – Lithotripsy

### ■ Lithotripsy

- Valuation potentially impacted by party providing services
- Valuation impacted by cost to party providing services
- Valuation impacted by comparability of services and the context of the comparable values
- Valuation impacted by the size of the agreement (*i.e.* number of clicks)

## Conclusions

- Make sure the valuation is consistent with the transaction
- Understand the methodology
- The methodology should be appropriate
- The Conclusions should be reasonable

# Questions and Answers

***Issues Impacting FMV in Complex Healthcare Arrangements***©2007 is published by the American Health Lawyers Association. All rights reserved. No part of this publication may be reproduced in any form except by prior written permission from the publisher. Printed in the United States of America.

Any views or advice offered in this publication are those of its authors and should not be construed as the position of the American Health Lawyers Association.

“This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought”—*from a declaration of the American Bar Association*