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Do Automated Valuation Tools Realize Their Value Proposition?

Using automation for systematized initial fair market value guidance when possible

By Albert "Chip" Hutzler, JD, MBA, CVA, Partner, HealthCare Appraisers

A staggering volume of transactions implicate the federal healthcare laws, with requirements that remuneration be consistent with fair market value (FMV).[1] The monumental logistical challenge is to accurately determine FMV, which is hardly straightforward[2] to begin with, and to do so consistently across a myriad of different deals.

At larger healthcare entities, such as multi-hospital systems, or pharmaceutical and device companies, there is an emerging new trend to handle this problem by utilizing one or more valuation tools (such as valuation frameworks or calculators) to help support a certain bolus of lower risk transactions. The beauty of this approach is in its ideal balance between the need to carefully manage budget and timeline considerations, coupled with the extra assurance offered by having the valuation tools independently developed or reviewed.

Regulatory considerations

The key passages of the Stark regulations and associated commentary that define FMV[3] provide fairly vague and disjointed guidance on how to determine FMV over numerous separate pronouncements.[4] CMS made it clear that internal valuations are allowed, stating:

"We agree that there is no requirement that parties use an independent valuation consultant for any given arrangement when other appropriate valuation methods are available. However, while internally generated surveys can be appropriate as a method of establishing fair market value in some circumstances, due to their susceptibility to manipulation and absent independent verification, such surveys do not have strong evidentiary value and, therefore, may be subject more intensive scrutiny than an independent survey."[5]

However, while internal valuation is allowed, the government guidance clearly indicates a preference for independent third-party appraisals, whenever possible. Simply put, CMS undoubtedly recognized that there are too many transactions that are subject to the FMV requirement to insist that all valuations be conducted by an independent third party. That said, a frequent remedy in settlements and corporate integrity agreements has been to require the settling party to obtain outside valuations for a subset of its riskier transactions for an agreed-upon period of time.[6] The key passage from the commentary above suggests that the government's concerns with internal appraisals are mainly bias, manipulation, rigor and consistency of internal valuations versus independent ones.[7]

Addressing the concerns effectively

In this context, the advantage of using valuation tools becomes clear, particularly when the tools have been developed or reviewed by a third-party independent appraiser. This approach significantly reduces the risks noted above by having a third party help develop tools that are largely free from bias and manipulation, and that contain the rigor and consistency sufficient to satisfy the substantial concern expressed by the regulators.

Tools of this kind take several forms. Some are frameworks that require some internal calculations based on deal terms and other inputs gathered by the user. Some frameworks will use rate tables based on varying parameters, while others will use a worksheet to determine applicable rates. Finally, a popular tool is an automated calculator tool, where the user enters various inputs and the automated tool generates the FMV guideline rates (or alternatively, it generates a finding as to whether the proposed rates are consistent with FMV).

Use of internal tools does not remove the ability to utilize outside analysis when needed. Because tools are automated, and cannot consider certain subjective factors, and because the valuator who developed the tool is not examining the facts directly, the tools have more limited applicability, and a direct analysis may be able to support arrangements that automated tools cannot. In effect, the automated tools provide baseline guidance, which may be sufficient to support a transaction, but if not, more detailed human analysis may be all that is needed.

In developing automated tools, that value of having an independent third party involved in creating the tools or at least reviewing the tools is considerable. Their independent knowledge and position helps ensure the tools are not biased and are used consistently and correctly. The third party provides the user with the additional assurance of knowing the tools are well-tested without having to independently review every deal. The third-party valuator should extensively test tools for many different scenarios to ensure they can provide an opinion which states that they believe the tool, if used correctly, yields values that are consistent with FMV.

Potential pitfalls to avoid

There is certainly a risk that the advantages of this approach could be defeated by sophisticated internal operators purposely misusing the system created by the tools, which after all are somewhat automated by nature. But if the tools are used correctly, the risk of problems should be substantially reduced over other internal approaches.

Perhaps more likely is not bad intent, but honest use of the tools within their parameters. However, the tools may be used in ways that were never intended or contemplated by the third-party valuator. Valuators who review or develop such tools must be aware of doing so, and they must carefully consider the possible avenues for tools to be used incorrectly or in unintended ways that might lead to problematic results.

Finally, internal valuation tools can assist with determining FMV, but one must always keep in mind that FMV is not the only element of the healthcare regulatory requirements. Commercial reasonableness is a separate element required of many deals, and similarly, most transactions cannot have compensation that is based in any way on the volume or value of referrals. Those two requirements are also key aspects of the healthcare law, and unlike FMV, they are notably more difficult to safeguard with any sort of framework or automated tool. In particular, commercial reasonableness is mostly a question of demonstrating the need for the transaction in the absence of referrals, which is normally a somewhat subjective inquiry.

Conclusion – The benefits are measureable

The trend toward use of frameworks and automated tools is noticeable and significant. Clearly, the benefits of using these type of tools, far outweighs the drawbacks, as there are simply too many transactions to have them all reviewed by an external appraiser. Given that a certain percentage of deals will be subject to internal review regardless, the ability to do that review with tools that provide extra protection over other types of internal approaches is worthy of strong consideration. The savings in time and effort alone is significant, but the real savings is in preventing costly and damaging problems down the road. ■

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References:

[1] Among the laws and regulations that may have FMV requirements are: (i) the Physician Self-Referral Prohibition or "Stark" law (42 U.S.C. §1395nn); (ii) the federal Anti-Kickback Statute (42 U.S.C. § 1320a-7b); (iii) Internal Revenue Service Private Benefit Guidance and Intermediate Sanctions rules (see Treas. Reg. 53.4958 et seq.); (iv) the Foreign Corrupt Practices Act (15 U.S.C. § 78dd-1); and others.

[2] The IRS first defined its FMV standard in Revenue Ruling 59-60, and the Stark law modified it in 42 U.S.C. § 1395nn(h)(3) and 42 CFR § 411.351. To get a sense how difficult FMV can be to determine in the context of the IRS and Stark definitions, consider the 947-page textbook on the subject entitled: "*BVR/AHLA Guide to Healthcare Industry Compensation and Valuation*," edited by Timothy Smith and Mark O. Dietrich (2012).

[3] 42 CFR § 411.351 contains the definition. Commentary on the Stark definition is found at: 72 Fed. Reg. 51015 (September 5, 2007); 69 Fed. Reg. 16107 (March 26, 2004); 66 Fed. Reg. 944 (January 4, 2001); and 63 Fed. Reg. 1686 (January 9, 1998).

[4] *See* note 3.

[5] 66 Fed. Reg. 945 (January 4, 2001).

[6] *See* for example, Corporate Integrity Agreement between OIG and HCA, Inc. (2000), and Deferred Prosecution Agreements between the U.S. Dept. of Justice and Stryker, Zimmer and other device manufacturers (2007).

[7] 66 Fed. Reg. 945 (January 4, 2001).