

HEALTH LAW CONNECTIONS

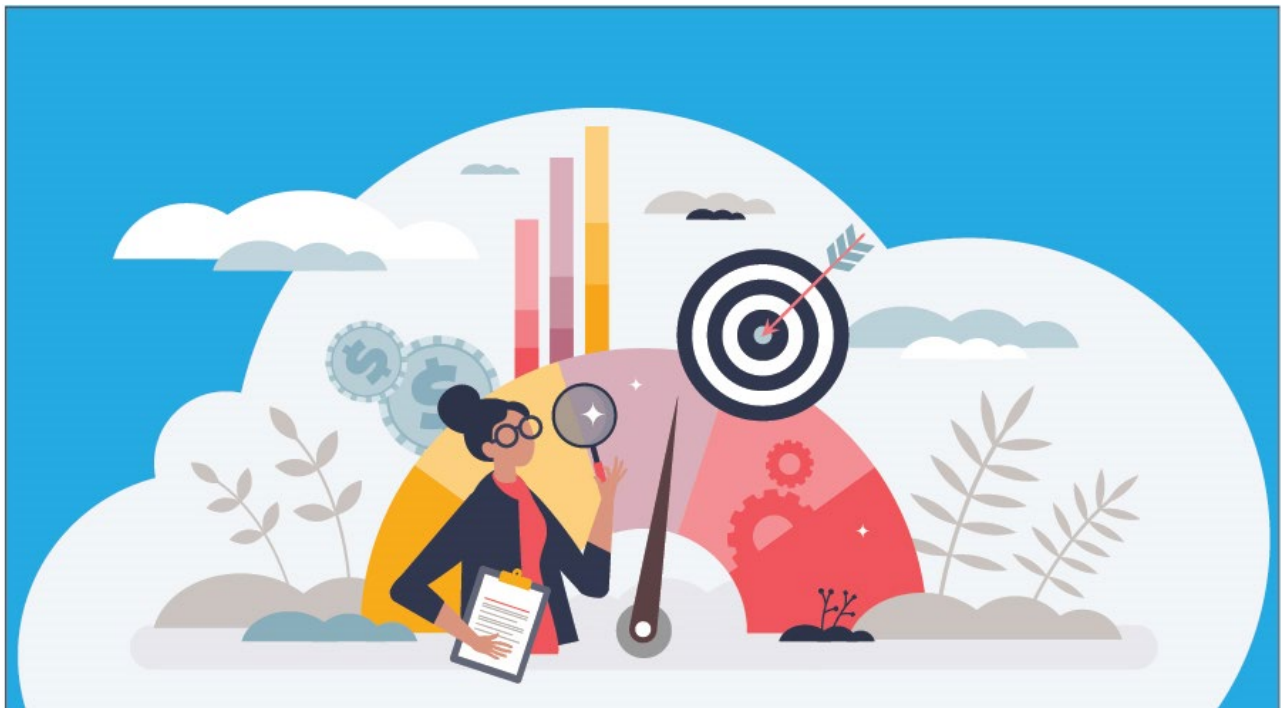
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Fair Market Value Opinions: Practical Tips for Engaging Third-Party Appraisers and Securing Client Buy-In During the Valuation Process

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Spend any amount of time in the health care industry and it won't take long to recognize the importance and prevalence of the term "fair market value" or "FMV." Particularly for attorneys who work on arrangements with physicians or other referral sources, FMV is a routine part of their practice. Structuring an arrangement that is consistent with FMV is not just a "nice-to-have," but rather is a necessary requirement for many types of health care arrangements. For example, many of the exceptions to the Physician Self-Referral Law (Stark),¹ including the employment exception, the personal services exception, the

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academic medical centers exception, the isolated transactions exception, the rental of space and equipment exceptions, and, not surprisingly, the fair market value exception, all require compensation paid under the arrangement to be consistent with FMV.² Additionally, for compensation under an arrangement that might implicate the Anti-Kickback Statute (AKS),³ the parties may seek to structure the arrangement to fit within an applicable AKS “safe harbor,” many of which include an FMV requirement.⁴ And, in arrangements involving tax-exempt and disqualified persons, the parties should confirm FMV to establish a rebuttable presumption in potential excess benefit situations.⁵

Stark and the Internal Revenue Service provide their own definitions of FMV, while the AKS and safe harbor regulations do not. Notably, however, none of them mandate a third-party FMV opinion to establish FMV.⁶ Still, obtaining an FMV opinion has for many years been a best practice in the health care industry for confirming FMV. While it is not a panacea for an otherwise non-compliant arrangement, an FMV opinion can serve as a powerful arrow in a party’s quiver to support the terms of an arrangement if they were ever to be scrutinized by enforcement authorities or a relator.

Naturally, attorneys who work on arrangements in which FMV is a key component devote substantial time to the valuation process. Yet despite the commonplace nature of appraisers and FMV opinions, many attorneys find the process time-consuming and tedious. Evaluating, selecting, and engaging an appraiser requires the attorney’s attention to administrative details, and working with the appraiser towards a final report requires the attorney to speak a language and understand terms and concepts that may be unfamiliar. If that’s not bad enough, attorneys might also field complaints from their clients involved in the underlying arrangement who view the valuation process as a distracting, check-the-box legal requirement that ties their hands as they work towards an agreeable deal with the other side.

The goal of this article is to highlight the various roles that the attorney and appraiser play during the valuation process, outline the items to consider when engaging and working with an appraiser, and provide practical recommendations to help educate clients about the importance of the valuation process and gain their trust to ensure they are committed to the valuation process from start to finish.

The Attorney’s Role in the Valuation Process

The attorney can serve several roles during the valuation process. Initially, before an appraiser is even engaged, the attorney should educate the client on what potential arrangements might require FMV and convince the client to include the attorney during the early stages of such arrangements. One compelling argument for including the attorney early in the process is that there may be instances when, due to the low-risk nature of the potential arrangement, an FMV opinion is not necessary, thereby removing a hurdle for the client. But the attorney must be involved to help guide and document that decision.

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Due to the attorney's understanding of the regulatory environment driving the need for FMV, another role for the attorney is to identify what, in particular, needs to be valued. By focusing on what is important, and clarifying what is not, the process will become more efficient, which can translate to a faster turnaround and a less costly report, both of which would be welcomed by the client.

The attorney's familiarity with the valuation process and with the client's operations can also place the attorney in a valuable position as facilitator between the appraiser and the client, particularly during the data collection phase of the valuation process. The attorney can be the first to review the appraiser's requests for data and might be able to answer several of them before they reach the client, which will allow the client to focus on fewer requests. For requests that the client can't answer, either because the information does not exist or cannot be easily gathered, the attorney might understand the underlying nature of the request and can suggest alternative responses that will supply the appraiser with the information it needs. This role as facilitator can also be useful to manage expectations for a client that has never engaged an appraiser or for appraisers who have never worked with the particular client.

The attorney's role as legal counsel—their primary role—is also important during the valuation process. When a decision is made to obtain an FMV opinion, the attorney should determine whether the appraiser needs to be engaged under the attorney-client privilege. If so, the attorney's engagement of the appraiser, whether the attorney is in-house or outside counsel, is one of the necessary components to bring the valuation process within the privilege. The attorney should instruct the appraiser to address the engagement letter to the attorney and include a statement that the engagement is intended to be covered by the attorney-client privilege, and the attorney should sign the engagement letter on behalf of the client. When the appraiser issues the final report, the report should also be addressed to the attorney. In the event of an investigation by the government into the underlying arrangement, the client will likely elect to waive the privilege and disclose the final report to demonstrate compliance with applicable laws and regulations. However, engaging the appraiser under the attorney-client privilege gives the client more control over when and how the final report is disclosed.

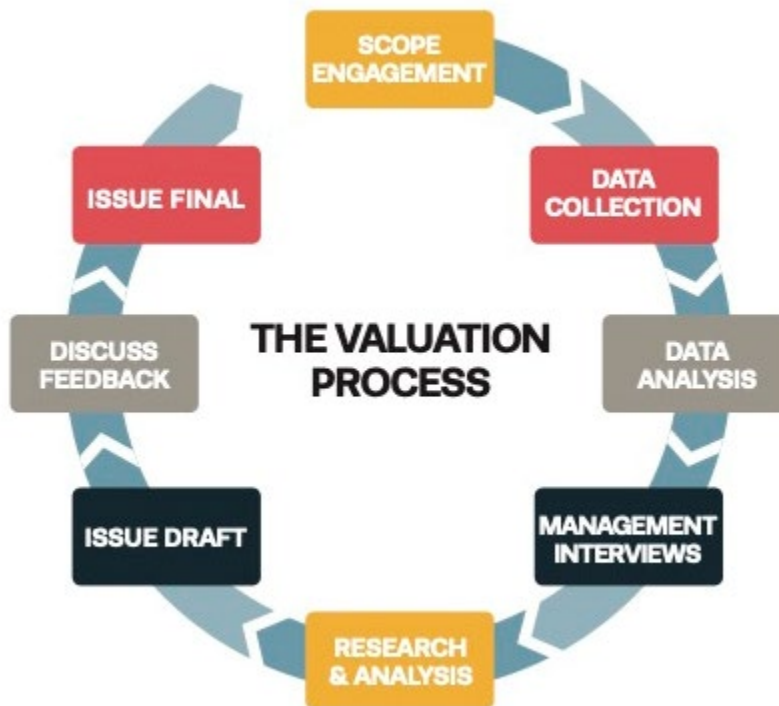
The Appraiser's Role in the Valuation Process

The appraiser's role in the valuation process is to function as an independent, third-party expert in determining the FMV of the asset(s) or business interest being transacted or the compensation consideration being paid through an employment or professional services agreement. While many appraisal firms employ appraisers who function as generalists, in that their professional practice spans a wide variety of industries, some choose to focus their practice specifically on the health care industry. This health care industry focus can be valuable to the process, because even though appraisers do not function as legal counsel, they are likely already familiar with the complex health care regulatory environment the attorneys and their clients are navigating. The appraiser's expertise in turn assists with a smooth engagement-scoping discussion and allows the appraiser to work with the attorneys and their clients in a collaborative fashion, potentially offering items to consider on a subject arrangement that the appraiser has seen implemented from other health care clients throughout the country.

While the valuation process is typically quantitatively focused given that consideration will be ultimately changing hands in an arrangement, the role of the appraiser includes ensuring the client understands the valuation methodologies implemented in a subject appraisal and explaining how valuation conclusions were arrived at in a subject engagement. The appraiser works closely with the client, attorney, and other client representatives throughout the entirety of the valuation process to ensure they have a firm understanding of the underlying subject asset, entity, or arrangement. The appraiser's goal is to present an objective, independent analysis that is defensible and reliable. An appraiser hopes to ensure that not only are the client, attorney, and other client representatives satisfied with the thorough and thoughtful outcome of an FMV opinion, but that the final report withstands any future scrutiny from regulators or auditors. To achieve this goal, many appraisers hold a valuation credential and prepare FMV opinions that are in-line with the appropriate standards of appraisal practice specific to their technical specialty.

The Valuation Process

Every aspect of the valuation process with an appraiser—from engagement, fees, and scope of work, to data collection, interviews, and final product—should be carefully considered by the attorney advising the client and should include the input of the client.



Engagement

When selecting an appraiser, especially for larger projects or if there is not already an ongoing arrangement with the appraiser, it may be helpful to interview a number of appraisal firms to determine whether the firms have experience in the particular matter to be valued, what the expected fees will be, and which members of the firm will be involved in the engagement. Including the client in the interview process can signal to the client that the client's input is valued, which can lead to the client feeling a sense of ownership in the valuation process. Securing early buy-in from the client can deepen the trust between the attorney and client and can lead to better communication between the client and the appraiser during the valuation process.

Using a single appraisal firm for most FMV engagements can improve familiarity between the appraisers working on the engagements and the attorney and client, which can improve the firm's understanding of the client's structure and operations, and its needs and goals for the arrangement. There are those within the health care industry, however, who believe

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that using the same appraiser for most or all FMV engagements may impinge on the appraisal firm's objectivity and have a negative impact on the credibility of the FMV opinion. Ultimately, regardless of the number of appraisal firms that are engaged, the appraisal firm, attorney, and client should work collaboratively to ensure that the appraisal firm is in the best position to produce high-quality, dependable work product.

When the appraisal firm is selected, the attorney should carefully review the engagement letter to confirm that the scope of the engagement, the fees, and the description of what is to be valued are accurate. As mentioned above, if the appraisal firm is being engaged under the attorney-client privilege, the engagement letter should include language to reflect that type of engagement. Also, it may be necessary to incorporate any standard terms and conditions that the client routinely adds to contracts, particularly consulting arrangements.

Appraisal firms may have different fee structures depending on the type of arrangement (hourly, flat fee, combination of both, etc.). Some firms are also willing to provide all valuations needed by the client in one or more areas of high volume (e.g., physician employment agreements) for a fixed monthly fee. Understanding that attorneys may view the engagement process as a time-consuming administrative task and that clients may view it as part of a larger compliance-related hurdle, an appraisal firm might seek to set itself apart by offering creative solutions to help make the overall engagement process as efficient and cost-effective as possible, such as offering fixed-monthly pricing for appraisal services, entering into a master engagement agreement, developing dynamic FMV calculators, or proposing other innovative solutions, depending on the needs of the client.

The engagement letter should establish whether the final report can be shared with third parties. If sharing the final report with third parties is prohibited, the attorney should request language to carve out from the prohibition the sharing with auditors, outside advisors, and outside legal counsel, at the very least. Whether the engagement is under attorney-client privilege may also limit the scope of who can see the final report without waiving the privilege.

In circumstances where the client might seek to jointly engage the appraisal firm along with one or more other parties involved in the arrangement, the attorney should advise as to whether the need to protect the attorney-client privilege will restrict that option. However, if the attorney-client privilege is not necessary, jointly engaging an appraisal firm will allow the fees to be split among multiple parties and will improve the confidence that opposing parties have in the final report, which may not be the case if only one party engages the firm. Joint engagement also eliminates dueling and potentially inconsistent final reports that might arise if the parties in an arrangement each retain their own appraiser.

Data Collection and Interviews

Using the scope of work in the engagement letter and the terms of the proposed arrangement as guides, the appraisal firm will begin data collection by furnishing the attorney and client with a written request for data, which will include requests for information and documents concerning the client and the proposed arrangement. The requests might also seek information and documents concerning the other party to the arrangement. In those cases, the attorney can relay the requests to the other party's attorney, or the client representatives can work directly with their counterparts on the other side to gather the requested information. For requests that seek a large amount of data or documents, the parties may elect to set up an online data room to facilitate the exchange of information. Alternatively, in instances where the other party is sensitive about disclosing certain data early in the negotiation process, the appraiser may offer to interact directly with the other party and agree not to disclose the information or documents, although the other party should understand that the information will be used by the appraiser in formulating the FMV opinion.

The appraiser will next engage in interviews with the client to learn more about the proposed arrangement. If the size of the arrangement dictates, or if the appraiser is working on multiple valuations for the client, the appraiser, attorney, and client would be well-served to meet regularly to discuss the status of the negotiations of the underlying arrangements, ensure the data inputs are accurate, and address questions and requests for clarification. A free flow of data from the client to the appraiser is necessary to allow the valuation process to run efficiently and ensure that the appraiser's opinion in the final report is accurate. To that end, the attorney and the appraiser should work to ensure the client views the appraiser as a part of the team working to complete the arrangement, and not an outsider from whom information must be withheld. Indeed, the client's feedback about its understanding of the other party's priorities and goals for the compensation terms of the arrangement can be particularly helpful, as the appraiser might be able to pull different compensation levers to arm the client with different compensation options for the client to propose to the other side, all of which would be consistent with FMV.

In that vein, if the client has in mind a specific consideration amount for the arrangement, it will be helpful to share that with the appraiser. The attorney and client should work with the appraiser to obtain at least a preliminary understanding of value before a particular amount is disclosed to or negotiated with the other party. This will avoid the awkwardness and difficulty of having to change expectations or the possibility of ending up in a situation in which an offer at a certain value has been made and accepted, which creates the potential for a binding contract at a number outside the range of FMV.

As part of the data collection and data analysis process, the appraiser may request a copy of any term sheets or letters of intent that have been drafted or executed, which will furnish the appraiser with a good background on the proposed arrangement as well as an idea of where the arrangement is heading. As noted above, it is best practice to obtain at least a

preliminary approval of the compensation terms from the appraiser before including such terms in a term sheet or letter of intent. If the parties can't wait on preliminary approval, the attorney should suggest that the compensation terms are identified as "FMV, as determined by the parties and confirmed by a third-party appraiser," or something to that effect. At the very least, the attorney should ensure such documents include contingency language stating that the compensation terms are subject to confirmation of FMV by a third-party appraiser.

Draft Report

When it has completed its data analysis, interviews, and research, the appraiser will issue a draft report on its opinion. In opining on FMV, the appraiser can confirm that a particular amount the parties have in mind is consistent with FMV, or alternatively, can propose a value or range of value. The attorney and client should carefully review the draft report to ensure the assumptions in the report used to support the opinion are accurate. The attorney and client should confirm that the draft report matches up with the scope of what was outlined in the engagement letter.

Generally, the report of the FMV opinion will contain a variety of information, much of which would be unsurprising, such as the date of the report, the intended users of the report, and the expiration date of the report (if applicable), among other items. However, the report will also contain items that may not be as obvious to those who do not read FMV opinions on a regular basis, and it may be specific to the underlying technical specialty of the FMV opinion that is being completed (e.g., real property appraisal, business valuation appraisal). For example, a business appraisal report should typically include a section that defines the "Premise of Value," which is an assumption regarding the most likely set of transaction circumstances that might be applicable to the subject valuation, such as either: (i) value as a going concern, (ii) value as an assemblage of assets; (iii) value as an orderly disposition, or (iv) value as a forced liquidation.⁷

Because the attorney and client engaging the appraiser are typically not valuation experts, it may be difficult for them to understand all the necessary sections that must be contained in an FMV opinion. However, at the onset of the engagement, the attorney or client can inquire about what professional standards, if any, the appraiser's reports comply with. For instance, a business valuation appraiser may indicate that its business valuation reports are drafted in compliance with the Uniform Standards of Professional Appraisal Practice (USPAP).⁸ By noting that a report is drafted in accordance with a specific body of knowledge that is widely accepted in the industry, the attorney and client can have greater peace of mind knowing that the subject report is likely not missing key items from its analysis and narrative.

While the report is in draft form, the attorney and client should take the opportunity to give feedback, ask questions, and provide the appraiser with any information that has changed

or information that was not previously supplied in order to clarify the valuation and improve the accuracy of the final report.

Final Report

Once any issues in the draft report have been resolved, the appraiser can issue a final report. However, the attorney and client may elect to delay finalizing the report until the arrangement is ready to be signed or closed. This is because in some cases, as the parties negotiate towards a final arrangement, information will be discovered or disclosed by the other party that could have an impact on the FMV opinion. If that happens, the appraiser can modify the draft report, if needed, without having to revise a report that has already been finalized. When the report is finalized, the attorney and client should maintain the report in their files in the event the report needs to be consulted in the future.

Don't Forget About Commercial Reasonableness

Some of the Stark Law exceptions and AKS safe harbors require that the arrangement be commercially reasonable.⁹ Commercially reasonable “means that the particular arrangement furthers a legitimate business purpose of the parties to the arrangement and is sensible, considering the characteristics of the parties, including their size, type, scope, and specialty. An arrangement may be commercially reasonable even if it does not result in profit for one or more of the parties.”¹⁰ In most cases, a party can independently determine whether an arrangement is commercially reasonable, and in those cases, the attorney should help document the terms that support the determination. However, there may be cases where it is advisable for the client to obtain a confirmation of commercial reasonableness from an appraiser. To make the confirmation, the appraiser will likely request additional information from the client and may charge an additional fee to add that component to the FMV opinion. The attorney should be aware of how commercial reasonableness will be handled when engaging the appraiser. Some appraisers will include commercial reasonableness confirmation as part of their standard FMV opinion process, while others will not do so unless it is specifically requested. If the attorney seeks a confirmation of commercial reasonableness from the appraiser, the attorney should ensure that it is specified in the engagement letter.

Conclusion

The compensation terms in many transactions within the health care area must be consistent with FMV. To satisfy that requirement, obtaining an FMV opinion from an experienced and qualified third-party appraiser is a best practice, although not a legal mandate. The attorney should be involved in all aspects of the valuation process, from interviewing and engagement to receipt of the draft and final reports, but should also take the opportunity to involve the client in many aspects of the process to ensure accuracy of the outcome and obtain buy-in from the client on the results.

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Nicholas Janiga is a partner with HealthCare Appraisers. He has been providing his clients expert analysis and consultation in acquisitions, joint ventures, intellectual property arrangements, healthcare provider compensation relationships, and disputes since 2006. Many of the transactions and arrangements he analyzes involve fair market value and commercial reasonableness opinions in the context of Physician Self-Referral Law, Anti-Kickback Statute, IRC 501(c)(3), among other applicable laws and regulations. He also has experience providing expert witness testimony in deposition and trial settings. Nicholas Janiga is an Accredited Senior Appraiser (ASA) in Business Valuation through the American Society of Appraisers and is a current member of AHLA.

Endnotes

¹ 42 U.S.C. § 1395nn.

² 42 C.F.R. § 411.357(c) (bona fide employment relationships exception); 42 C.F.R. § 411.357(d) (personal service arrangements exception); 42 C.F.R. § 411.355(e) (academic medical centers exception); 42 C.F.R. § 411.357(f) (isolated transactions exception); 42 C.F.R. § 411.357(a) (rental of office space exception); 42 C.F.R. § 411.357(b) (rental of equipment exception); 42 C.F.R. § 411.357(l) (fair market value compensation exception).

³ 42 U.S.C. § 1320a-7b.

⁴ *E.g.*, 42 C.F.R. § 1001.952(b) (space rental safe harbor); 42 C.F.R. § 1001.952(c) (equipment rental safe harbor); 42 C.F.R. § 1001.952(d) (personal services and management contracts and outcomes-based payment arrangements safe harbor).

⁵ 26 C.F.R. § 53.4958-4(b)(1)(i).

⁶ 42 C.F.R. § 411.351; IRS Revenue Ruling 59-60.

⁷ Shannon P. Pratt and ASA Educational Foundation, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (6th ed.).

⁸ For further information on

USPAP, see [https://www.appraisalfoundation.org/imis/TAF/Standards/Appraisal Standards/Uniform Standards of Professional Appraisal Practice/TAF/USPAP.aspx](https://www.appraisalfoundation.org/imis/TAF/Standards/Appraisal%20Standards/Uniform%20Standards%20of%20Professional%20Appraisal%20Practice/TAF/USPAP.aspx).

⁹ *E.g.*, 42 C.F.R. § 411.357(a)(6) (rental of office space exception); 42 C.F.R. § 411.357(b)(5) (rental of equipment exception); 42 C.F.R. § 411.357(c)(3) (bona fide employment relationships exception); 42 C.F.R. § 411.357(f)(2) and (3) (isolated transactions exception); 42 C.F.R. § 1001.952(b)(6) (space rental safe harbor); 42 C.F.R. § 1001.952(c)(6) (equipment rental safe harbor); 42 C.F.R. § 1001.952(d)(i)(vi) (personal services and management contracts and outcomes-based payment arrangements safe harbor).

¹⁰ 42 C.F.R. § 411.351.