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Todd A. Zigrang, MBA, MHA, ASA, FACHE, Publisher • Jessica L. Bailey, Esq., Editor ©

The Threshold of Commercial Reasonableness

In response to the advent of accountable care and value-based reimbursement, which emerging reimbursement models rely on for achieving better outcomes at lower cost, hospitals are increasingly seeking closer relationships with physicians, including direct employment, co-management, and joint ventures.[1] Corresponding with this growing trend toward hospital-physician alignment, there has been increased federal, state, and local regulatory oversight regarding the legal permissibility of these arrangements. Most notably, there has been more intense regulatory scrutiny related to the *Anti-Kickback Statute* (AKS) and the *Stark Law*, especially as they relate to potential liability under the *False Claims Act* (FCA).[2] In FY 2013, the U.S. *Department of Justice* (DOJ) opened 1,013 new criminal healthcare fraud investigations and 1,083 new civil healthcare fraud investigations, an increase from the 878 criminal healthcare fraud investigations and 776 civil healthcare fraud investigations opened in FY 2007.[3]

Valuation analysts should note that the fraud and abuse laws scrutinize many aspects of healthcare transactions, including physician compensation arrangements, under both the valuation standard of *fair market value* (FMV) and the separate, but related, threshold of "*commercial reasonableness*".[4] It is critical to obtain and maintain appropriate documentation that any given physician compensation arrangement (whether it be for clinical services, administrative services, on-call services, or a combination of services) meets both the standard of FMV and the *commercial reasonableness* threshold in order to withstand regulatory scrutiny. Typically, legal counsel does not provide opinions as to the *commercial reasonableness* of a compensation arrangement,[5] and will most often retain and rely upon an independent valuation consultant to provide a certified valuation opinion that the arrangement does not exceed FMV and meets the requirements of *commercial reasonableness*. Due to the increase in healthcare transactions, notably from the first to second quarter of 2014,[6] opinions related to the threshold of *commercial reasonableness* of healthcare transactions are becoming an "*increasingly important service offered by healthcare valuation professionals*."[7] This three-part Health Capital Topics series will address the components of a defensible *commercial reasonableness analysis* (CR analysis) and the importance of this analysis in today's increasingly scrutinized healthcare marketplace.

Rendering a *commercial reasonableness* opinion requires that a specific set of *core competencies* be mastered by the valuation analyst *apart from*, but *related to*, the more traditional *knowledge*, *skill set*, and *experience* required in rendering FMV opinions related to the appraisal of the *enterprises*, *assets* and/or *services* being transacted. The key components of a CR analysis include both a consideration of the *qualitative* factors that affect the *commercial reasonableness* opinion, as well as a *quantitative* analysis of the elements of the anticipated transaction of the subject enterprise, asset or service.[8] This first installment will address the definitions of *commercial reasonableness* and illuminate the subtle differences of *commercial reasonableness* definitions among federal regulatory bodies in order to provide indications as to the manner of assessing the factors and elements within the CR analysis.

While definitions of the *commercial reasonableness* threshold are similar among the various federal agencies tasked with enforcing regulations affecting the healthcare industry, there are subtle nuances between each agency's interpretation of the term "*commercial reasonableness*." The *Department of Health and Human Services* (HHS) has interpreted the term "*commercially reasonable*" to mean an arrangement which appears to be *"…a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals."*[9] Additionally, HHS's *Stark II, Phase II* commentary suggests 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 of similar scope and specialty, even if there were no potential DHS [designated health services] referrals.*"[10]

The *Internal Revenue Service* (IRS) and *Office of the Inspector General* (OIG) have also provided guidance in defining *commercial reasonableness*. IRS guidance regarding *commercial reasonableness* may be derived from IRS pronouncements on *reasonable compensation*,

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including:

(1) The 1993 Exempt Organizations IRS text titled "*Reasonable Compensation*," which states that "*reasonable compensation is…the amount that would ordinarily be paid for like services by like organizations in like circumstances*;"[11]

(2) Chapter 2 of Publication 535, titled "*Business Expenses*," which states "*…reasonable pay is the amount that a similar business would pay for the same or similar services*;"[12] and,

(3) Federal Regulations on "*Excess Benefit Transactions*," which state, "*reasonable compensation [is]…the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances*."[13]

It should be noted that no IRS pronouncement defining *reasonable compensation* specifically addresses the healthcare industry. However, these factors provide indications as to the manner of assessing *commercial reasonableness* thresholds in an anticipated healthcare transaction.

Additionally, the OIG has defined a *commercially reasonable* transaction as one in which "*…the aggregate services contracted do not exceed those which are reasonably necessary to accomplish the commercially reasonable business purpose of the service*."[14]

Further guidance indicating that, beyond the *individual transaction elements*, the *entirety* of a *subject transaction* should be reviewed in the *aggregate* (inclusive of *all elements* for which consideration is given) is found in the *Personal Services* exception of the *Stark Law*. This exception requires that "*[t]he aggregate services contracted for do not exceed those that are reasonable and necessary for the legitimate business purposes of the arrangement(s).*"[15]

For transactions involving *aggregate* services, analysts must account for all elements of the integrated transaction in their *commercial reasonableness* opinions. Commonly referred to as a "*wrap around*" *commercial reasonableness* opinion, this type of analysis includes and considers *all elements* of the integration transaction in the *aggregate*, subsequent to the determination that each discrete, individual element of the transaction meets the thresholds of the standards of FMV and *commercial reasonableness*. With complex acquisitions involving multiple property interests, a "*wrap around*" CR analysis provides a foundation upon which to establish and defend that the healthcare transaction is legally permissible and will withstand government scrutiny.

While the analysis of the threshold of *commercial reasonableness* is separate and distinct from the development of a FMV analysis, requiring consideration of different aspects of the property interest included in the transaction, they are *related* thresholds, and the consideration and analysis of one threshold does *not* preclude the analysis of the other threshold. For example, a necessary condition for an anticipated transaction to be *commercially reasonable* is that each element of that transaction must not exceed FMV. However, even in the event that each element of an anticipated transaction does not exceed FMV, the anticipated transaction may still *not* be *commercially reasonable*, in that it does not meet the remaining analytical hurdles of a CR analysis. Consequently, a finding that an enterprise, asset or service meets the FMV threshold is not, in and of itself, *sufficient* to establish *commercial reasonableness*.[16]

A further distinction between a CR analysis and the development of a FMV opinion is that the *commercial reasonableness* thresholds include consideration of the "*…value to the entity paying for…*"[17] the enterprise, assets or services being transacted, while the FMV opinion requires that a *universe of hypothetical buyers, sellers, owners* and *investors* be considered. For example, consider the acquisition of ten linear accelerators by a purchaser. If the purchaser has need of only one linear accelerator, the purchase of ten linear accelerators even at a FMV price would not meet the *necessity of the assets purchased* threshold of the *commercial reasonableness* analysis.[18]

Mastering the foundational principles for a CR analysis – including accurately understanding the definitions of *commercial reasonableness*, as well as the differences between an FMV opinion and a CR analysis – is essential before an analyst undertakes a CR analysis on behalf of a client. In an era of increasing regulatory scrutiny and growing healthcare transaction volume, accurately grasping the nuances of *commercial reasonableness* definitions can improve the analyst's understanding of the scope and objectives of a certified *commercial reasonableness* opinion regarding a particular transaction. Further, properly applying these definitions within the *qualitative* and *quantitative* analyses can increase the defensibility of the opinion, thereby supporting efforts of healthcare providers to establish a defensible position that their proposed transaction is in compliance.

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13 "Excess Benefit Transaction", 26 CFR § 53.4958-4(b)(1)(ii) (2012).

14 "Subpart C: Permissive Exclusions – Exceptions" 42 C.F.R. § 1001.952 (2012).

15 "Exclusions from Medicare and Limitations on Medicare Payment" 42 C.F.R. § 411.357(d)(1)(iii) (2012).

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17 "Medicare and State Health Care Programs: Fraud and Abuse: Clarifications of the Initial OIG Safe Harbor Provisions and Establishment of Additional Safe Harbor Provisions Under the Anti-Kickback Statue", 64 Federal Register 63526 (11/19/99).

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Robert James Cimasi, MHA, ASA, FRICS, MCBA, CVA, CM&AA, serves as Chief Executive Officer of **HEALTH CAPITAL CONSULTANTS** (HCC), a nationally recognized healthcare financial and economic consulting firm headquartered in St. Louis, MO, serving clients in 49 states since 1993. Mr. Cimasi has over thirty years of experience in serving clients, with a professional focus on the financial and economic aspects of healthcare service sector entities including: valuation consulting and capital formation services; healthcare industry transactions including joint ventures, mergers, acquisitions, and divestitures; litigation support & expert testimony; and, certificate-of-need and other regulatory and policy planning consulting.

Mr. Cimasi holds a Masters in Health Administration from the University of Maryland, as well as several professional designations: Accredited Senior Appraiser (ASA – American Society of Appraisers); Fellow Royal Institution of Chartered Surveyors (FRICS – Royal Institute of Chartered Surveyors); Master Certified Business Appraiser (MCBA – Institute of Business Appraisers); Accredited Valuation Analyst (AVA – National Association of Certified Valuators and Analysts); and, Certified Merger & Acquisition Advisor (CM&AA – Alliance of Merger & Acquisition Advisors). He has served as an expert witness on cases in numerous courts, and has provided testimony before federal and state legislative committees. He is a nationally known speaker on healthcare industry topics, the author of several books, the latest of which include: "*Accountable Care Organizations: Value Metrics and Capital Formation*" [2013 - Taylor & Francis, a division of CRC Press], "*The Adviser's Guide to Healthcare*" – Vols. I, II & III [2010 – AICPA], and "*The U.S. Healthcare Certificate of Need Sourcebook*" [2005 - Beard Books]. His most recent book, entitled *"Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services"* was published by John Wiley & Sons in March 2014.

Mr. Cimasi is the author of numerous additional chapters in anthologies; books, and legal treatises; published articles in peer reviewed and industry trade journals; research papers and case studies; and, is often quoted by healthcare industry press. In 2006, Mr. Cimasi was honored with the prestigious "*Shannon Pratt Award in Business Valuation*" conferred by the Institute of Business Appraisers. Mr. Cimasi serves on the Editorial Board of the Business Appraisals Practice of the Institute of Business Appraisers, of which he is a member of the College of Fellows. In 2011, he was named a Fellow of the Royal Institution of Chartered Surveyors (RICS).

Todd A. Zigrang, MBA, MHA, ASA, FACHE, is the President of **HEALTH CAPITAL CONSULTANTS** (HCC), where he focuses on the areas valuation and financial analysis for hospitals and other healthcare enterprises. Mr. Zigrang has significant physician integration and financial analysis experience, and has participated in the development of a physician-owned multi-specialty MSO and networks involving a wide range of specialties; physician-owned hospitals, as well as several limited liability companies for the purpose of acquiring acute care and specialty hospitals, ASCs and other ancillary facilities; participated in the evaluation and negotiation of managed care contracts, performed and assisted in the valuation of various healthcare entities and related litigation support engagements; created pro-forma financials; written business plans; conducted a range of industry research; completed due diligence practice analysis; overseen the selection process for vendors, contractors, and architects; and, worked on the arrangement of financing.

Mr. Zigrang holds a Master of Science in Health Administration and a Masters in Business Administration from the University of Missouri at Columbia. He is a Fellow of the American College of Healthcare Executives, and serves as President of the St. Louis Chapter of the American Society of Appraisers (ASA). He has co-authored *"Research and Financial Benchmarking in the Healthcare Industry"* (STP Financial Management) and *"Healthcare Industry Research and its Application in Financial Consulting"* (Aspen Publishers). He has additionally taught before the Institute of Business Appraisers and CPA Leadership Institute, and has presented healthcare industry valuation related research papers before the Healthcare Financial Management Association; the National CPA Health Care Adviser's Association; Association for Corporate Growth; Infocast Executive Education Series; the St. Louis Business Valuation Roundtable; and, Physician Hospitals of America.

Matthew J. Wagner, MBA, CFA, is Senior Vice President of **HEALTH CAPITAL CONSULTANTS** (HCC), where he focuses on the areas of valuation and financial analysis. Mr. Wagner has provided valuation services regarding various healthcare related enterprises, assets and services, including but not limited to, physician practices, diagnostic imaging service lines, ambulatory surgery centers, physician-owned insurance plans, equity purchase options, physician clinical compensation, and healthcare equipment leases.

John R. Chwarzinski, MSF, MAE, is Vice President of **HEALTH CAPITAL CONSULTANTS** (HCC). Mr. Chwarzinski holds a Master's Degree in Economics from the University of Missouri – St. Louis, as well as, a Master's Degree in Finance from the John M. Olin School of Business at Washington University in St. Louis. Mr. Chwarzinski's areas of expertise include advanced statistical analysis, econometric modeling, and economic and financial analysis.

Jessica L. Bailey, Esq., is the Director of Research of **HEALTH CAPITAL CONSULTANTS** (HCC), where she conducts project management and consulting services related to the impact of both federal and state regulations on healthcare exempt organization transactions and provides research services necessary to support certified opinions of value related to the Fair Market Value and Commercial Reasonableness of transactions related to healthcare enterprises, assets, and services. Ms. Bailey is a member of the Missouri and Illinois Bars and holds a J.D. and Health Law Certificate from Saint Louis University School of Law, where she served as Fall Managing Editor for the Journal of Health Law and Policy.