

Healthcare Valuation Series: A Look at Fair Market Value and Commercial Reasonableness

The four-part [*HC Topics Series: Healthcare Valuation*](#) will examine various aspects of the process by which healthcare enterprises, assets, and services are appraised. Part I will discuss the application of the *fair market value* and *commercial reasonableness* standards utilized by various regulatory agencies; Part II will address the valuation of intangible assets; Part III will address the valuation of services; and, Part IV will conclude with a discussion of several of the more complex aspects of valuation related to the acquisition of physician practice enterprises (and service lines); assets (both intangible and tangible); and, services, by exempt organizations. This *HC Topics Series* is excerpted from the book authored by HCC President Bob Cimasi, entitled, “*Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services*,” to be published by John Wiley & Sons later this year.

Much of healthcare valuation relies on the standard of *fair market value (FMV)* as the nexus of regulatory compliance, and application of a different standard of value may place the healthcare entity, as well as the appraiser, at risk for legal sanctions and enforcement actions. Additionally, many healthcare arrangements are scrutinized under the related threshold of *commercial reasonableness*. Typically, legal counsel does not provide a legal opinion as to *FMV* or *commercial reasonableness* and will most often retain an independent valuation consultant to provide a certified valuation opinion as to the *FMV* and/or *commercial reasonableness* of a compensation arrangement for a given employment or services agreement, including agreements for clinical professional services, medical directorships and on-call coverage, as well as other administrative, management and executive management services.¹ This article will provide an in-depth discussion of *FMV* and *commercial reasonableness* as they are applied in the valuation of healthcare transactions.

Corresponding with the growing trend toward hospital employment of physicians, there has been an increase in regulatory scrutiny related to the legal permissibility of these arrangements under the federal fraud and abuse laws as they relate to transactions between healthcare providers. *FMV* is implicated by three distinct bodies of law which regulate compensation arrangements between hospitals and physician employees. Federal Fraud and

Abuse laws, such as the Stark Law and the federal Anti-Kickback Statute, generally prohibit compensation arrangements between parties in a position to refer patients to each other. Further, the Internal Revenue Service (IRS) scrutinizes compensation arrangements between tax-exempt organizations and their employees to ensure that such arrangements do not constitute *excess benefit transactions* in violation of an organization’s tax-exempt status. Within the heightened regulatory environment in which healthcare providers operate, and given the severity of regulatory penalties for entering into legally impermissible arrangements, it is critical to ensure that compensation arrangements are both at *FMV* and *commercially reasonable* in order to withstand scrutiny from enforcing agencies, the Office of Inspector General (OIG) and the IRS.

Business valuation principles define the standard of *FMV* as the most probable price that the subject interest should bring if exposed for sale on the open market, as of the valuation date, but exclusive of any element of value arising from the accomplishment or expectation of the sale. This standard of value assumes an anticipated hypothetical transaction, in which the buyer and seller are each acting prudently with a reasonable equivalence of knowledge, and in which the price is not affected by any undue stimulus or coercion. Federal fraud laws define *FMV* somewhat differently, however. Under Stark II Phase I, the Health Care Financing Administration (HCFA; now CMS) defined *FMV* as “*the value in arm’s-length transactions, consistent with general market value.*”² “*General Market Value*” is defined as: “[T]he price that an asset would bring as a result of bona fide bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation 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, on the date of acquisition or the asset or at the time of the service agreement.”³

FMV is also a critical requirement under several safe harbors to the federal Anti-Kickback Statute.⁴ While *FMV* is not specifically defined within the Anti-Kickback Statute, the OIG has provided guidance on this issue and stated that: “*When considering the*

question of fair market value [FMV], we would note that the traditional or common methods of economic valuation do not comport with the prescriptions of the Anti-Kickback statute. Items ordinarily considered in determining the FMV may be expressly barred by the Anti-Kickback statute's prohibition against payments for referrals. Merely because another buyer may be willing to pay a particular price is not sufficient to render the price to be paid FMV. The fact that a buyer in the position to benefit from referrals is willing to pay a particular price may only be a reflection of the value of the referral stream that is likely to result from the purchase.⁵ Some Anti-Kickback regulations do specifically define FMV in reference to safe harbor provisions, such as those for lease agreements involving real property or equipment.⁶ However, these definitions vary with the context of the applicable safe harbor, and several other safe harbor provisions do not include an explicit definition of FMV, thereby leading to further regulatory uncertainty.⁷

In addition to the FMV standards contained in the Stark Law and the Anti-Kickback Statute, Section 501(c)(3) of the Internal Revenue Code also uses an FMV standard. The IRS defines FMV as "the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts."⁸ Under any definition, however, FMV looks to the "range of dollars" paid for a product or service, while the threshold of *commercial reasonableness* looks to the "totality of the circumstances" surrounding a compensation agreement to determine the reasonableness of the *business arrangement generally*.⁹ These are related, but distinct, thresholds that must *both* be met, i.e., a compensation arrangement may be simultaneously at FMV and still be determined to *not* be *commercially reasonable*.

While no explicit definition of *commercial reasonableness* exists, when taken together, available guidance from several regulatory sources indicates the meaning of the term. In its 1998 proposed Stark regulations, the HCFA interpreted "*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."¹⁰ The Stark II, Phase II commentary expanded on this definition, suggesting 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 referrals."¹¹

To withstand scrutiny under federal fraud and abuse laws, a 2006 American Law Institute publication suggests that "[e]ach financial and contractual connection between hospitals and physicians should be scrutinized to ensure that goods or services changing hands are being provided at fair market value, and at a level no more than necessary for the business purposes of the arrangement."¹² To ensure *commercial reasonableness* then, it is important to scrutinize whether an entity is making sound business judgments in light of its size, the number of patients it accommodates, and the needs of those patients, as well as the market service area in which the provider is located and the needs of the community it serves.¹³ When considering physician compensation, it is imperative that the hospital cannot obtain the same services from a non-referral physician at a cheaper rate or under more favorable terms, and for the arrangement to survive scrutiny, both *services and payments* must be considered *commercially reasonable*.¹⁴ Compensation arrangements will likely be deemed *commercially reasonable* if: (1) the arrangements are at FMV; (2) the arrangements list the actual duties being performed by the physician; (3) the services performed are reasonably necessary to the provider based on the details of the situation; and, (4) the services could not be adequately provided for less compensation.

For tax-exempt entities, compensation arrangements that do not satisfy the *commercial reasonableness* standard under the Stark law and the Anti-Kickback statute will also likely implicate federal tax-exemption rules.¹⁵ A related, but somewhat distinct, concept from the *commercial reasonableness* standard of the Stark law and Anti-Kickback statute, is the *reasonable* standard the IRS applies to compensation arrangements entered into by tax-exempt organizations. The IRS has developed a *rebuttable presumption*, which consists of a three-prong test to determine whether a compensation agreement offered by a tax-exempt entity is *reasonable*, and thus safe from *intermediate sanctions* by the IRS.¹⁶ A *rebuttable presumption* is established if: (1) the arrangement is approved in advance by an authorized body whose members have no conflicts of interest; (2) the compensation has been set based on a reliance of comparable data; and (3) the authorizing body adequately, and concurrently, documented the basis for its determination.¹⁷ Such a compensation arrangement is then presumed to be *reasonable*, and a transfer of property, or the right to use such property, is presumed to be at FMV.¹⁸ While the IRS does not require tax-exempt organizations to meet all three prongs of the *rebuttable presumption* when setting executive compensation, failure to meet any part of the test suggests an *excess benefit transaction* may have occurred and thus places the tax-exempt organization at risk for immediate *intermediate sanctions*, as well as the potential to lose its tax-exempt status.¹⁹

Case law also provides some guidance for establishing *FMV* and *commercial reasonableness*. Courts have developed analytical approaches to determining if a compensation arrangement will survive fraud and abuse scrutiny, particularly by looking to whether physicians are actually performing the services outlined in the arrangement, e.g. whether they are working the volume of hours anticipated by the arrangement. Because healthcare transactions must comport with sound business practices and survive stringent regulatory scrutiny, valuation approaches must take into account not only business valuation definitions of *FMV* and *commercial reasonableness*, but also various applicable regulatory definitions and guidance. Next month's installment of the *HC Topics Series: Healthcare Valuation* will examine the valuation of intangible assets.

1 "Fair Market Value: Analysis and Tools to Comply with Stark and Anti-kickback Rules," By: Robert A. Wade, Esq. & Marcie Rose Levine, Audioconference, HCPro, Inc., Mar. 19, 2008, <http://content.hcpro.com/pdf/content/207583.pdf> (Accessed 10/11/12), p.49.
2 66 Fed. Reg. 944 (Jan. 4, 2001).
3 42 C.F.R § 411.351 (2008); Wade & Levine, p. 34.
4 "Fair Market Value: The Lawyer's Perspective," By Kimberley Elting et al., Health Care Compliance Forum, Oct. 2006; see 42 C.F.R. 1001.952.
5 Elting et al, 2006; "Letter from D. McCarty Thornton," Associate General Counsel, Office of Inspector General (HHS) to T.J. Sullivan, Technical Assistant, office of the Associate Chief Counsel, Employee Benefits and Exempt Organizations, Dec. 22, 1992, <https://oig.hhs.gov/fraud/docs/safeharborregulations/acquisition122292.htm> (Accessed 10/11/12).
6 "Exceptions," 42 C.F.R. section 1001.952 (2006); section 1001.952(b)(6); section 1001.952(c)(6).

7 For example, the personal services and management contracts exception found in 42 C.F.R. section 1001.952(d) (2006).
8 26 CFR 53.4958-4(b)(i).
9 "Tread Carefully When Setting Fair Market Value: Stark Law Must Be Considered," Joyce Frieden, Nov. 1, 2003, <http://www.thefreelibrary.com/Tread+carefully+when+setting+fair+market+value%3A+Stark+law+must+be...-a0110804605> (Accessed 10/11/12).
10 63 Fed. Reg. 1700 (Jan. 9, 1998).
11 69 Fed. Reg. 16093 (March 26, 2004).
12 "Healthcare Joint Ventures," By Alson R. Martin, American Law Institute, SM047 ALI-ABA 1093 (2006).
13 "Fair Market Valuation Report, U.S. ex rel. Kaczmarczyk v. SCCI Health Services Corp.," U.S. District Court for the Southern District of Texas, Filed July 12, 2005, p. 4.
14 "OIG Supplemental Compliance Program Guidance for Hospitals," 70 Fed. Reg. 4866-67 (Jan. 31, 2005); Wade & Levine, p. 44.
15 "The Physician Compensation Committee" By Michael Peregrine et al., McDermott Will & Emery, American Health Lawyers Association, September 2009, http://www.mwe.com/info/pubs/AHLA_InHouse_0909.pdf (Accessed 10/17/12), p. 3.
16 Treasury Regulations, § 53.4958-6(a)(1)-(3).
17 Ibid; "An Introduction to I.R.C. 4958 (Intermediate Sanctions)" By Lawrence M. Brauer et al., Internal Revenue Service, 2002, <http://www.irs.gov/pub/irs-tege/eotopich02.pdf> (Accessed 10/11/12), pp. 270-273.
18 Treasury Regulations, § 53.4958-6(a)(1)-(3); Brauer et al., p. 270-273.
19 See Brauer et al., p. 270, 274, 286, 326; "Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II," By Internal Revenue Service, March 2007, p.8, http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf (Accessed 10/11/12); see "IRS Issues Final Excess Benefit Rules on When Exemptions May be Threatened," BNA Health Law Reporter, April 3, 2008, http://healthlawrc.bna.com/hlrc/4237/split_display.adp?fedfid=7139940&vname=hlrcmotallissues&wsn=533644000&searchid=18619116&doctypeid=9&type=odate4news&mode=doc&split=0&cm=4237&pg=0 (Accessed 10/11/12).



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