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Threshold of Commercial Reasonableness: The Qualitative Analysis

Due to the heightened legal and regulatory scrutiny of healthcare related transactions, the issuance of *commercial reasonableness* opinions is a growing area of focus for professional advisors and consultants in the healthcare industry. As set forth in the previous installment of this three-part Health Capital Topics series on *commercial reasonableness*, there is no single, universally accepted definition of *commercial reasonableness*; however, guidance for its interpretation can be gleaned from: the Internal Revenue Code (IRC), Treasury Regulations, other Internal Revenue Service (IRS) publications and pronouncements related to *reasonable compensation*; *Office of Inspector General* (OIG) Advisory Opinions and pronouncements; Anti-Kickback Regulations; the US Public Health Code; and, pertinent case law.

To assess the *commercial reasonableness* of a proposed transaction, the valuation analyst should begin with certain prerequisite elements, including:

(1) Whether each element of a prospective transaction does not exceed *fair market value*; and,
(2) That the prospective transaction is a sensible, prudent business arrangement even in the absence of referrals.[1]

Pursuant to the Stark Law, Congress has explicitly stated that the requirement that the transaction be a sensible, prudent business arrangement in the absence of referrals applies to several elements of physician-hospital transaction, including the following:

(1) "*Rental of office space*;
(2) *Rental of equipment*;
(3) *Bona fide employment relationships*;
(4) *Personal service arrangements*;
(5) *Physician incentive plans*;
(6) *Physician recruitment*;
(7) *Isolated transactions, such as a one-time sale of property*; and,
(8) *Certain group practice arrangements*."[2]

The OIG for the *U.S. Department of Health and Human Services* (HHS), in its interpretation of whether a prospective transaction considered the volume or value of referrals, looks for any financial arrangement which may induce a physician to change their referral pattern, such as:

(1) *"…[A]rrangements [to] promote overutilization and…unnecessarily lengthy stays*;"[3] and,
(2) "*…[P]ayments to induce physicians…to reduce or limit services to…patients*."[4]

Therefore, transactions that take into consideration "*the value or volume of referrals*" will not meet the regulatory threshold of a *commercial reasonableness* analysis.[5]

After ensuring that each element of the prospective transaction does not exceed *fair market value*; and, that the transaction would be a sensible, prudent business arrangement, even in the absence of referrals, further analysis of both the *qualitative* and *quantitative* aspects of the proposed transaction is warranted to determine its *commercial reasonableness*.

The steps involved in the *qualitative* assessment of *commercial reasonableness* focus on determining the acquirer's business purpose(s), and how the anticipated transaction assists in meeting that purpose. The specific *qualitative* thresholds are as follows:

(1) Is the integration transaction necessary to accomplish the business purpose of the client;
(2) Does the nature and scope of the underlying elements of the integration transaction meet the business needs of the client;
(3) Does the enterprise and organizational elements of the integration transaction make business sense to the client;
(4) Does the quality, comparability, and availability of the underlying elements of the integration transaction make business sense for the client;
(5) Are there sufficient ongoing assessments, management controls, and other compliance measures in place related to the underlying elements of the integration transaction; and,
(6) Is the transaction otherwise legally permissible?[6]

In determining whether the transaction fulfills a "*…business purpose…*"[7] for the acquirer, the OIG and the IRS have provided definitional guidance, as follows:

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(1) HHS commentary on the *Anti-Kickback Statute* (AKS) regulations considers transactions to have a *business purpose* if they can be "*reasonably calculated to further the business of the lessee or acquirer*;"[8] and,

(2) The IRS defines *business activities* as those "*…carried on for the production of income from the sale of goods or the performance of services*."[9]

One element that may indicate a *sensible, prudent business arrangement* is the *anticipated economic benefit* to be derived from the *financial profitability* resulting from the transaction. It should be noted that economic benefit can be derived from both *monetary* and *non-monetary* sources; however the ultimate source of value is the *expected utility* to be derived from the ownership of a property interest. Financial remuneration (i.e., cash), in fact, is an intermediary economic benefit, whose value emanates from its exchange for an asset which directly provides utility. Utility from a transaction may arise from economic benefits other than short-term profitability, including:

(1) Expansion into new geographic areas;[10]

(2) Expansion into new business lines;[11]

(3) Augmenting existing service lines;[12]

(4) Diversification benefits;[13]

(5) Avoiding costs of establishing offices and facilities, management, and other resources, in place;[14]

(6) Operating expense reductions;[15]

(7) Increased asset utilization;[16]

(8) Reduced cost of capital and greater access to capital;[17]

(9) Horizontal integration;[18]

(10) Vertical integration;[19]

(11) Management and care protocols;[20]

(12) Increased access to technology and innovation;[21]

(13) Improved research & development;[22] and,

(14) Tax motivation.[23]

While these synergistic gains to a specific owner or investor, which would likely not be considered when performing a *fair market value* analysis, they may be a significant factor in establishing that a transaction is *commercially reasonable*.[24]

For a tax exempt 501(c)(3) organization, which must be *"…organized and operated exclusively for an exempt purpose…"*[25] such as, *"charitable, religious, educational, scientific,… [or] public safety…,"*[26] financial losses may be incurred to adhere to Revenue Ruling 69-545, as it relates to healthcare enterprises, which states, *"In the general law of charity, the promotion of health is considered to be a charitable purpose. […] A nonprofit organization whose purpose and activity are providing hospital care is promoting health and may, therefore, qualify as organized and operated in furtherance of a charitable purpose."*[27] This *charitable mission* provides the basis for the healthcare enterprises tax-exempt status, whereby presumably, in lieu of a *cash return benefit*, the tax-exempt organization will, in the service of their stated charitable mission, generate a *social benefit* for the community it serves. This *social benefit* may take the form of *indigent care* provided to the community in which the non-profit organization operates (note that, some for-profit healthcare organizations do provide indigent care but their incentive to provide this care may be different from that of charitable, non-profit organizations, which by mandate must provide the care), which may provide improved public health, a benefit that accrues to all members of the community. A further example of *social benefit* is the evolving mission and objective of tax-exempt hospitals, which has grown to include their role as *organizers* and *integrators* of care in a community, whereby they provide a *continuum of care* across a population, which may not necessarily be profitable, but are nonetheless necessary for the *health of the population* in that community.

In assessing the necessity of the subject property interest to the purchaser, the OIG suggests that an analysis be performed as to whether "*…the items and services obtained… [are] necessary to achieve a legitimate business purpose of the [employer] (apart from obtaining referrals)*."[28] In addition, guidance related to the *commercial reasonableness* threshold of necessity may be gleaned from IRS pronouncements and regulations used in determining whether an item is considered a "*reasonable business expense*." For example, the IRS requires a determination of whether the property interest is "*necessary*"[29] for the business purpose of the purchaser, i.e., "*helpful and appropriate for the trade or business*,"[30] in light of the "*the volume of business handled*"[31] the number of "*beds, admissions, or outpatient visits*;"[32] "*the complexities of the business*;"[33] and/or, the "*size of the organization*."[34]

Further guidance from the HHS commentary on the AKS suggests that analysts should determine how the "*space, equipment, or services*" meet the "*…lessee or purchaser needs, intents to utilize, and…commercially reasonable business objectives*."[35] To determine the necessity of the subject property interest to the acquirer, a valuation analyst may consider the following:

(1) The prevalence and incidence of disease;

(2) The relative frequency of demographic and behavioral risk factors associated with diseases in the market service area, associated state(s), and the United States;

(3) The population trends of the market service area, associated state(s), and the United States;

(4) Current treatment options for the injury, ailment, or disease treated by the subject provider(s);

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(5) The supply of physicians and other providers in the market service area, associated state(s), and the United States;

(6) The level of competition related to the subject property interest within the market service area;

(7) The economic costs related to disease in the market service area, associated state(s), and the United States; and,

(8) The payor environment in the market service area, associated states(s), and the United States.

Additionally, a *commercial reasonableness* opinion should include a determination as to whether the *nature* and *scope* of the property interest meet the business *needs* of the acquirer. Guidance regarding the *nature* and *scope* threshold of the *commercial reasonableness* analysis may, similarly to the *necessity* threshold, be gleaned from IRS pronouncements and regulations used to determine whether an item is a reasonable business expense. For example, the IRS has advised that the nature and scope of services provided should be analyzed to determine as to whether their cost is:

(1) A "*cost of carrying on a trade or business*;"[36]

(2) Undertaken "*for the production of income from the sale of goods or the performance of services*;"[37]

(3) "*…[P]aid or incurred during the taxable year*;"[38]

(4) "*…[R]easonable in terms of the responsibilities and activities…assumed under the contract*;"[39] and,

(5) "*…[R]easonable in relation to the total services received*."[40]

Next, a *commercial reasonableness* opinion should include an analysis of the anticipated transaction in light of various *enterprise* and *organizational elements* of the acquirer. The IRS pronouncements regarding *reasonable compensation* for tax purposes indicate that a determination should be made as to whether the *consideration paid* for the property interest is "*…a sensible, prudent business agreement…*"[41] for the acquirer. This determination is made within the context of:

(1) "*[T]he pay compared with the gross and net income of the business*;"[42]

(2) The "*business policy regarding pay for all employees*;"[43]

(3) "*[T]he cost of living in the locality*,"[44] based on an analysis of the "*national and local economic conditions*"[45] including whether the acquirer is located in a "*…rural, urban, or suburban*"[46] area; and,

(4) The structure, size, and location of the purchaser.[47]

As discussed above, tax exempt organizations must be organized and operated for an exempt purpose, and therefore, a *commercial reasonableness* analysis should consider whether the proposed transaction meets the exempt organization's *charitable mission*.

Another qualitative element of a *commercial reasonableness* analysis is whether the *quality*, *comparability*, and *availability* of the services, assets, and enterprises included in the anticipated transaction fit into the business purpose of the acquirer. The IRS pronouncements on *reasonable compensation* for tax purposes suggest that a *commercial reasonableness* analysis consider "*the ability and achievements of the individual performing the service*,"[48] including "*education*;"[49] "*specialized training and experience of the*" individual;[50] "*the history of pay for the employee*;"[51] and, "*…the availability of similar services in the geographic area*."[52] Additionally, the OIG advises that a *commercial reasonableness* analysis consider "*…the skill level and experience reasonably necessary to perform the contracted services*,"[53] especially if "*…the services [could be obtained] from a non-referral source at a cheaper rate or under more favorable terms*."[54] Finally, the Code of Federal Regulations specifies that when conducting an assessment as to the *commercial reasonableness* of a prospective transaction, valuation analysts should consider "*the type, expected life, condition…and market conditions in the area…[for] facilities or equipment*…,"[55] as well as whether "*adequate alternative facilities or equipment that would serve the purpose are not or were not available at lower costs*."[56]

Other elements of the transaction which may not fit neatly into the above discussed categories include:

(1) The "*…quality of management and interdisciplinary coordination*."[57] The government's expert witness report in the *U.S. v. SCCI Hospital Houston Central* case suggested that healthcare entities should conduct "*a regular assessment of the actual duties performed by the [employee]...[and] it should be clear how effective the [employee] is doing his assigned job and if there is a bona fide need for continuing the services*."[58]

(2) In the *U.S. v. Carlisle HMA, Inc.*, case, the Court ruled that healthcare entities need to determine whether the current "*consideration given and received [is paid] under materially different circumstances*"[59] than when the contract was entered.

(3) The OIG advises consultants to review transactions to determine if:

(a) "*the arrangements flow from an open, competitive request for proposal process…*;"[60]

(b) "*the risk that the arrangements will result in an appropriate utilization…*;"[61]

(c) "*the arrangements are…likely to have a negative effect on patient care*;"[62] and,

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(d) "*the arrangements…have an adverse impact on competition*."[63]

(4) A determination as to whether compensation for professional physician services does not exceed the level of collections for those services. In its appellate brief for the U.S. ex rel. Drakeford v. Tuomey case, the Department of Justice (DOJ) stated:

> "*Obert-Hong dealt with physician compensation arrangements where – unlike the Tuomey arrangements – the physicians did not earn more than their personal collections, and where there was no other basis to presume that the physicians were being paid for actual or anticipated referrals*." [64]

Within this statement, the DOJ implied that physician compensation arrangements where physicians are compensated for their professional services in excess of the collections generated by those services, might be considered by the government to be payment for *actual* or *anticipated referrals*, which would violate both the standard of *fair market value* and the threshold of *commercial reasonableness*. Further, the government's expert in the Tuomey case concluded that the physician contracts in question were "*commercially unreasonable*" since: *"… among other things,* [the physician contracts] *did not protect the financial interest of the hospital*,"[65] finding specifically that:

(a) "*The term of the physician employment agreements is ten years without provisions to change the physicians' compensation methodology*;

(b) *The physicians'' net outpatient collections are not required to exceed their practice overhead and their base salary before bonuses were earned*;

(c) *Combined with the cost of billing fees, each physician's compensation and benefits paid materially exceeded his or her Tuomey outpatient collections; and,*

(c) *Since their inception, Tuomey's physician practices have incurred material financial losses.*"[66]

Even in the event that a transaction meets all of the foregoing qualitative elements, the transaction may not be considered *commercially reasonable* if it is not otherwise legally permissible. Four federal legal edicts in particular significantly influence healthcare transactions:

(1) Antitrust law; [67]

(2) The Stark Law;[68]

(3) The AKS; [69] and,

(4) The Internal Revenue Code.[70]

Of note is that, while valuation analysts must be versed in the rules and regulations surrounding the industry in which they provide services, typically, they do not offer or provide legal opinions. Thus, many *commercial reasonableness* opinions include a provision that states legal counsel has reviewed the arrangement and considers the proposed transaction to be legally permissible.

Standing alone, a transaction that overcomes the hurdles associated with the qualitative analysis is not yet deemed to be *commercially reasonable*; the analyst must then perform a *quantitative analysis* as part of its determination of *commercial reasonableness*. The final part of this three-part series concerning the threshold of *commercial reasonableness* will address the *quantitative analysis* performed by valuation analysts as part of rendering a *commercial reasonableness* opinion.

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