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Hot Topics in Healthcare Valuation

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Speaker Disclosure

Neither speaker has relevant financial relationship with commercial interest to disclose.

Presenter Bio

Roger D. Strode, Esq., is a partner and health care business lawyer with Foley & Lardner LLP where his practice focuses on health care business transactions, including mergers, acquisitions, corporate restructurings and joint ventures, general corporate matters and health care regulation. His experience includes the representation of institutional health care providers (hospitals, health systems and integrated delivery systems), large physician groups, specialty providers (ASC development organizations), health care private equity firms and industry consultants. Mr. Strode is a member of the firm's Health Care Industry Team.

Mr. Strode has participated as lead counsel in numerous health care and corporate transactions, including the purchase and sale, or transfer of sponsorship of hospitals, health systems, physician practices and health maintenance organizations; the formation of specialty hospitals; and the formation of ancillary services joint ventures.

Presenter Bio

Todd A. Zigrang, MBA, MHA, FACHE, ASA is the President of **HEALTH CAPITAL CONSULTANTS** (HCC), where he focuses on the areas of valuation and financial analysis for hospitals, physician practices, and other healthcare enterprises. Mr. Zigrang has over 20 years of experience providing valuation, financial, transaction and strategic advisory services nationwide in over 1,000 transactions and joint ventures involving acute care hospitals and health systems; physician practices; ambulatory surgery centers; diagnostic imaging centers; accountable care organizations, managed care organizations, and other third-party payors; dialysis centers; home health agencies; long-term care facilities; and, numerous other ancillary healthcare service businesses. Mr. Zigrang is also considered an expert in the field of healthcare compensation for physicians, executives and other professionals.

Mr. Zigrang is the author of the soon-to-be released "*Adviser's Guide to Healthcare – 2nd Edition*" (AICPA, 2014), numerous chapters in legal treatises and anthologies, and peer-reviewed and industry articles such as: *The Accountant's Business Manual* (AICPA); *Valuing Professional Practices and Licenses* (Aspen Publishers); *Valuation Strategies*; *Business Appraisal Practice*; and, *NACVA QuickRead*. Additionally, Mr. Zigrang has served as faculty before professional and trade associations such as the American Society of Appraisers (ASA); the National Association of Certified Valuators and Analysts (NACVA); the Physician Hospitals of America (PHA); the Institute of Business Appraisers (IBA); the Healthcare Financial Management Association (HFMA); and, the CPA Leadership Institute.

Overview

- The threshold of commercial reasonableness
- The value of medical practices in the absence of positive net cash flow
- The valuation of service lines separately from the valuation of the medical practice
- The various components of physician compensation, including clinical (e.g., RVU or salary); coverage and call; medical directorship; and, administrative

Commercial Reasonableness Definition

- Internal Revenue Service
  - The 1993 Exempt Organizations IRS text "*Reasonable Compensation*"
    - "*Reasonable compensation is…the amount that would ordinarily be paid for like services by like organizations in like circumstances*." [emphasis added]
  - Chapter 2 of Publication 535 "*Business Expenses*"
    - "*…reasonable pay is the amount that a similar business would pay for the same or similar services*" [emphasis added]
  - Federal Regulations on "Excess Benefit Transactions"
    - "*reasonable compensation [is]…the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances*." [emphasis added]

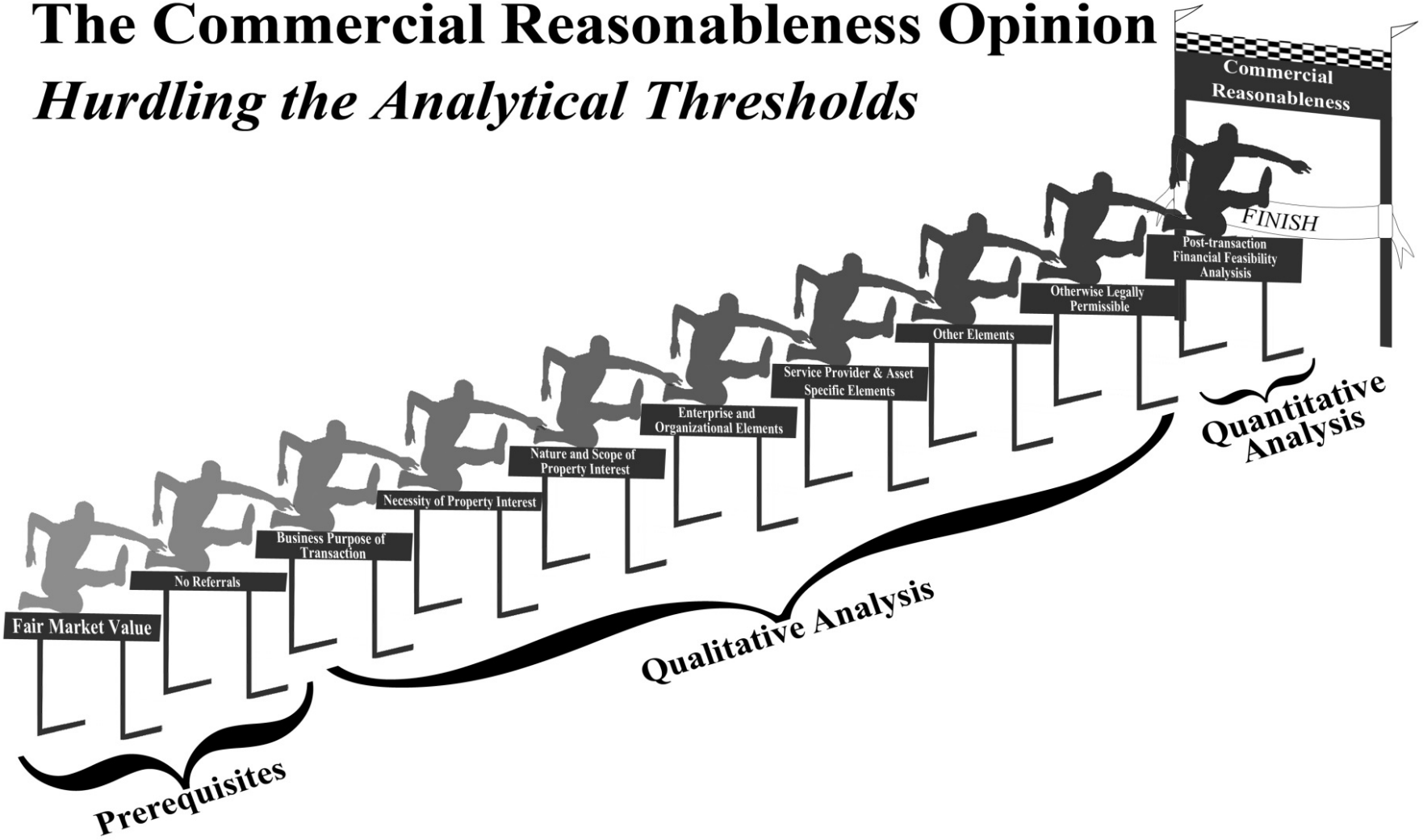
"Publication 535 - Business Expenses", Internal Revenue Service, 3/4/13, p. 6, http://www.irs.gov/pub/irs-pdf/p535.pdf (Accessed 4/1/13).

Commercial Reasonableness Definition

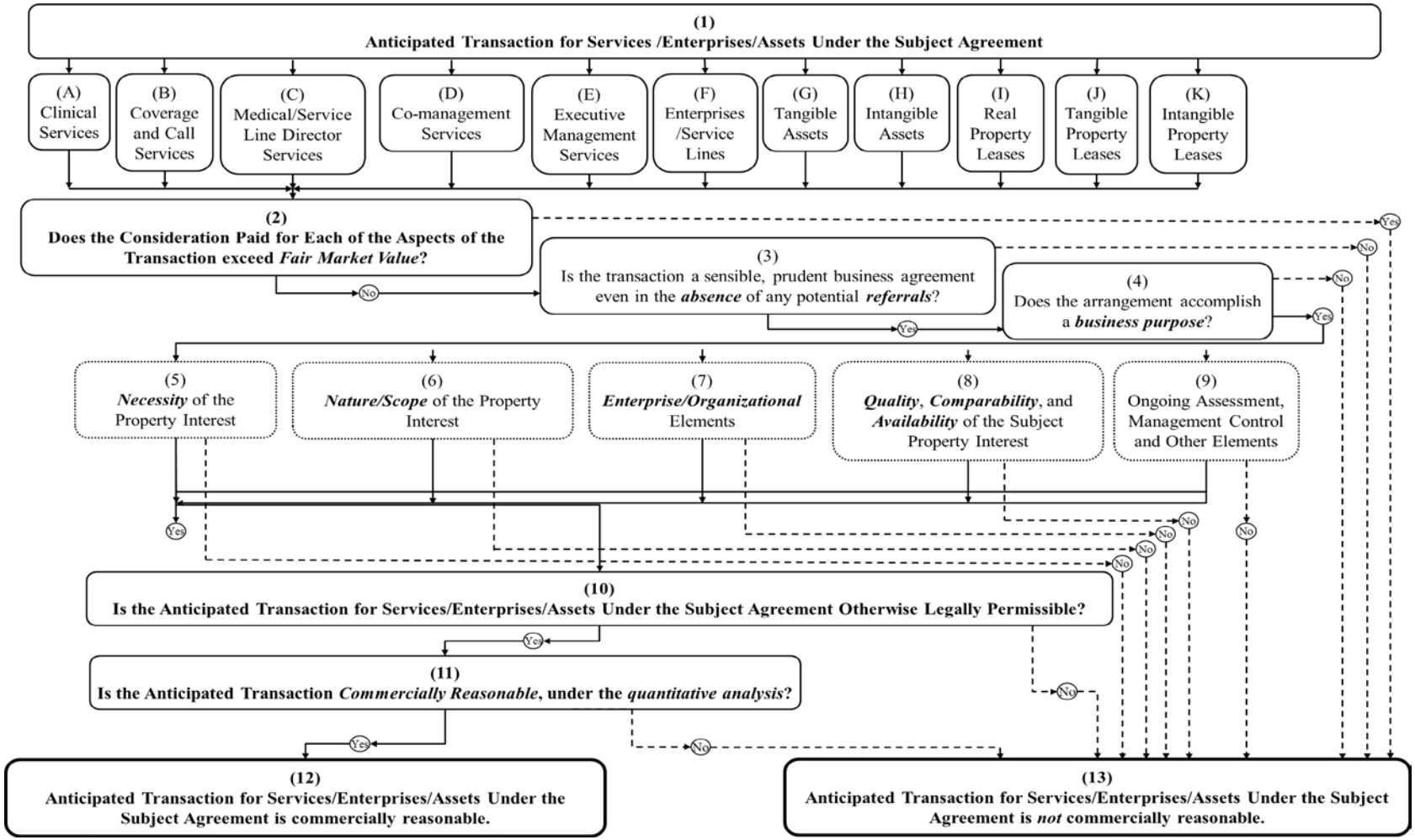
- Department of Health and Human Services
  - An arrangement which appears to be "*…a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals*" is commercially reasonable
- Stark Law
  - "*An arrangement will be considered '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.*"
- Office of the Inspector General
  - A commercially reasonable transaction is a transaction in which "*…the aggregate services contracted* do not exceed those which are reasonably necessary *to accomplish the commercially reasonable business purpose of the service*." [emphasis added]

Publication 535 - Business Expenses", Internal Revenue Service, 3/4/13, p. 6, http://www.irs.gov/pub/irs-pdf/p535.pdf (Accessed 4/1/13). "Medicare Program: Physicians' Referrals to Healthcare Entities with which They Have Financial Relationships (Phase II)", 69 Federal Register 16093 (3/26/04).

Commercial Reasonableness Analysis



Steps in Determining Commercial Reasonableness



"Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services," By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, John Wiley & Sons Inc., 2014, p. 941.

Relationship to FMV and Distinguished from FMV

- While FMV looks to the "*range of dollars*" paid for a product or service, the threshold of *Commercial Reasonableness* looks to the reasonableness of the business transaction generally
- *Commercial Reasonableness* is a *separate and distinct*, but related, threshold to a FMV analysis
- Furthermore, the consideration and analysis of one threshold does *not* preclude the analysis of the other threshold

"Excess Benefit Transaction", 26 CFR Section 53.4958-4(ii) (2012). "Subpart C: Permissive Exclusions - Exceptions", 42 CFR Section 1001.952 (2012).
"Tread Carefully When Setting Fair Market Value: Stark Law Must Be Considered," Joyce Frieden, Nov. 1, 2003, available at http://findarticles.com/p/articles/mi_moCYD/is_/ai_110804605 (Accessed 9/26/08).

Value of Medical Practices in the Absence of Positive Net Cash Flow

- *Contrasting viewpoints in the valuation community surrounding issues related to the valuation of intangible assets in physician practice enterprises:*
  - Existence of value for intangible assets of a healthcare professional practice enterprise in the absence of positive net cash flow being generated by the operations of the entity in its entirety
- *Valuation methodologies available for use by the valuation analyst, that:*
  - Are legally permissible
  - Have a sound theoretical economic and financial foundation
  - Are feasible to implement in practice

Positive Net Cash Flow *not* Required to Support Value of an Intangible Asset

Aggregate Cash Flow Versus Incremental Cash Flows

- Cash flow of an enterprise in its entirety is an aggregation of multiple *contributory* incremental cash flows
- *"the sum of the parts does not equal the whole"*
- The *incremental cash flow* generated by certain of the assets owned by the enterprise may be negative, and of a *sufficient magnitude* to offset the positive incremental cash flows of the aggregation of the remaining assets
- The value of the tangible assets would not necessarily be impaired by the existence of intangible assets that are not generating positive cash flow

"Valuation of Property" by James Bonbright, Volume I, New York, NY: McGraw Hill Book Company, Inc., 1937, p. 76-82.

Positive Net Cash Flow *not* Required to Support the Value of an Intangible Asset

Highest and Best Use of the Invested Capital

- In the event that a business enterprise *fails* to produce sufficient evidence to indicate a reasonable likelihood that it would, *as a going concern enterprise*, in the reasonably foreseeable future, be able to generate *sufficient economic benefit* to support the invested capital utilized to generate the revenue stream of the enterprise, the valuation premise of *Value in Use as a Going Concern* cannot be supported, and the adoption of the *Value in Exchange* premise of value is indicated

"Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services" by Robert James Cimasi, Volume II, Hoboken, NJ: John Wiley & Sons, 2014, p. 28.

Healthcare Regulations Regarding Valuation Methodologies and Intangible Assets

The Healthcare Industry Regulatory Environment Precludes the Use of Income Based Approaches in Valuing Certain Healthcare Related Intangible Assets

- ***Stark*** prohibits a physician from making a referral of designated health services to an entity with which the physician, or the physician's family member, has a financial relationship, and where payment for such a service may be made under Medicare.
  - **Exceptions to the Stark Laws are available, and payments made under those arrangements** may not be determined in a manner that takes into account the volume or value of any referrals or other business generated between the parties in order to be in compliance
- ***AKS*** deems it a felony to solicit, offer, receive, or pay remuneration of any kind for the referral of a patient for healthcare services paid by federal healthcare programs
  - **Safe Harbors to AKS are available, and payments made under those arrangements** may not be determined in a manner that takes into account the volume or value of any referrals or other business generated between the parties in order to be in compliance

"Limitation on certain physician referrals" 42 U.S.C. § 1395nn(a)(1); "Limitation on certain physician referrals" 42 U.S.C. § 1395nn(e)(1)(A)(iv); "Limitation on certain physician referrals" 42 U.S.C. § 1395nn(e)(1)(B)(iv); "Limitation on certain physician referrals" 42 U.S.C. § 1395nn(e)(2)(B)(ii); "Limitation on certain physician referrals 42 U.S.C. § 1395nn(e)(3)(A)(v); See generally "Exceptions to the referral prohibition related to compensation arrangements" 42 C.F.R. § 411.357; "Criminal Penalties for Acts involving Federal health care programs" 42 U.S.C. § 1320a-7b; "Exceptions" 42 C.F.R. § 1001.952(b)(5); "Exceptions" 42 C.F.R. § 1001.952(c)(5); "Exceptions" 42 C.F.R. § 1001.952(d)(5).

Healthcare Regulations Regarding Valuation Methodologies & Intangible Assets

- *The U.S. ex rel. Singh v. Bradford Regional Medical Center* case held that the appraiser, who utilized an *income approach to value* the healthcare professional practice intangible asset, comprised of a covenant not to compete, took into account the *volume or value of referrals* in determining the value of the property interest
- The Bradford case is important to valuation professionals due to its holding, which infers that income based approaches may not be appropriate when appraising certain intangible assets of medical practices, as doing so may raise an inference that the volume or value of referrals has been considered in determining payments for those assets

"Limitation on certain physician referrals" 42 U.S.C. § 1395nn(a)(1); "Limitation on certain physician referrals" 42 U.S.C. § 1395nn(e)(1)(A)(iv); "Limitation on certain physician referrals" 42 U.S.C. § 1395nn(e)(1)(B)(iv); "Limitation on certain physician referrals" 42 U.S.C. § 1395nn(e)(2)(B)(ii); "Limitation on certain physician referrals 42 U.S.C. § 1395nn(e)(3)(A)(v); See generally "Exceptions to the referral prohibition related to compensation arrangements" 42 C.F.R. § 411.357; "Criminal Penalties for Acts involving Federal health care programs" 42 U.S.C. § 1320a-7b; "Exceptions" 42 C.F.R. § 1001.952(b)(5); "Exceptions" 42 C.F.R. § 1001.952(c)(5); "Exceptions" 42 C.F.R. § 1001.952(d)(5).

Valuation of Service Lines separately from Valuation of the Medical Practice

Two general types of services provided by a physician practice

Professional Component

Work Requiring Physician or Mid-Level Provider Contribution of Time and Effort

Ancillary Services & Technical Component (ASTC)

Services that are ancillary to physician services and/or technical related, not requiring physician contribution

"Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services," By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Hoboken, NJ: John Wiley & Sons, 2014, Vol. II, p. 571-572.

Valuation of Service Lines separately from Valuation of the Medical Practice

- In healthcare, the appraisal of a service line that is integrated into a physician practice needs to address 2 controlling issues:
  - Under professional valuation standards, the disclosure of the use of a hypothetical condition is required to value an existing ASTC service line that is integrated with a physician professional practice, as a hypothetical, stand-alone enterprise
  - Significant attention must be paid to ensure that transaction does not run afoul of the specific regulatory restrictions pertaining to valuation of healthcare enterprises

"Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services," By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Hoboken, NJ: John Wiley & Sons, 2014, Vol. II, p. 572.

Valuation of Service Lines separately from Valuation of the Medical Practice

- Isolation of the net economic benefit to be produced by the subject "*carve out*" ASTC enterprise includes the following:
  - *Identifying the procedures* to be included
  - *Separating out the technical only, ASTC revenue stream*
  - *Determining the most probable economic operating expense burden* that would be incurred to produce the *technical only* ASTC revenue stream
  - *Determining the most probable economic capital expense burden* that would be incurred to produce the *technical only* ASTC revenue stream

Physician Compensation Benchmarking Sources

	A	B	C	D	E
	Name	Publisher	Clinical	Medical Director	On-Call
1	Medical Group Compensation and Financial Survey	American Medical Group Association	×	×	
2	Cost Survey for Single-Specialty Practices	Medical Group Management Association	×		
3	Physician Compensation and Productivity Survey Report	Sullivan Cotter and Associates, Inc.	×	×	×
4	Physician Compensation Survey	National Foundation for Trauma Care	×		
5	Physician Executive Compensation Survey	American College of Physician Executives		×	
6	Physician Compensation and Production Survey	Medical Group Management Association	×		
7	Physician Salary Survey Report: Hospital-Based Group HMO Practice	John R. Zabka Associates	×	×	
8	Survey Report on Hospital and Healthcare Management Compensation	Watson Wyatt Data Services		×	
9	Cost Survey for Multispecialty Practices	Medical Group Management Association	×		
10	Healthcare Executive Compensation Survey	Integrated Healthcare Strategies		×	
11	Physician On-Call Pay Survey Report	Sullivan Cotter and Associates, Inc.			×
12	Management Compensation Survey	Medical Group Management Association		×	
13	Survey of Manager and Executive Compensation in Hospitals & Health Systems	Sullivan Cotter and Associates, Inc.		×	
14	Executive Compensation Assessor	Economic Research Institute		×	
15	Top Management and Executive	Abbott Langer Association, Economic Research Institute, and Salaries Review		×	
16	Executive Pay in the Biopharmaceutical Industry	Top 5 Data Services, Inc.		×	
17	Executive Pay in the Medical Device Industry	Top 5 Data Services, Inc.		×	
18	Hospital Salary & Benefits Report, 2007-2008	John R. Zabka Associates, Inc.		×	
19	US IHN Health Networks Compensation Survey Suite	Mercer, LLC		×	
20	Intellimarker	American Association of Ambulatory Surgery Centers	×	×	
21	Medical Directorship and On-Call Compensation Survey	Medical Group Management Association		×	×

Physician Clinical Services

Gainsharing

- Arrangement "*under which a hospital gives physicians a share of the reduction in the hospital's costs (that is, the hospital's cost savings) attributable in part to the physicians' efforts*"
- Historically, gainshraing has been found to violate the **Civil Monetary Penalty Statute** (prohibits hospital for providing a payment to a physician as an inducement to reduce services) and **Anti-Kickback Statute**
- **2005**: OIG began to approve gainsharing arrangements due to benefits of decreased costs and increased quality
- **2009 Physician Fee Schedule** solicited comments regarding a possible new exception to **Stark Law** for shared savings programs (despite CMS's own concern for potential abuse)

"2009 Physician Fee Schedule Proposed Rule," 73 Fed. Reg. 23692-94 (Apr. 30, 2008).

Physician On-Call Services

Growing Need for Compensation for Provision of On-call Services Due to:

- Physician shortage and increased demand due to aging Baby Boomers
- Aging physician workforce
- Physicians demanding more "***regular***" work hours
- Physicians increasingly building practice through participation in ambulatory surgery centers and physician-owned specialty hospitals
- Physicians often receive inadequate payment for services provided while on-call as patients in the ED are often uninsured or under-insured

"OIG Advisory Opinion No. 07-10," Office of the Inspector General, Department of Health and Human Services, September 2007, www.oig.gov. "OIG Advisory Opinion No. 09-05," Office of the Inspector General, Department of Health and Human Services, May 2009, www.oig.gov.

Physician On-Call Services

OIG Approval of On-Call Compensation Arrangements

- **September 2007 (Opinion 07-10)**
  - First advisory opinion addressing on-call compensation arrangements
  - Physician's paid per-diem rate for on-call duties
  - On-call arrangement had sufficient safeguards to prevent Fraud – almost met the **Personnel Services and Management Safe Harbor**
    - Per Diem rates tailored to physician's burden and likelihood of response
    - Independent third party determined per diem rates were at ***FMV***
    - Payment not affected by volume or value of referrals
    - All physicians had equal on-call coverage, payment not higher for certain specialties

OIG Advisory Opinion No. 07-10," Office of the Inspector General, Department of Health and Human Services, September 2007, www.oig.gov.

Physician On-Call Services

OIG Approval of On-Call Compensation Arrangements May 2009 (Opinion 09-05)

- Physicians paid on-call compensation for services to patients ineligible for Medicaid/other state health insurance programs - payment covered physician fees, emergency & inpatient services
- Valuation methodology for compensation considered patient acuity, average length of stay, and physician time
- On-call arrangement had sufficient safeguards to prevent Fraud – almost met the Personnel Services and Management Safe Harbor
- Payments to physicians for services rendered, rather than availability (e.g., "*lost opportunity*")

OIG Advisory Opinion No. 09-05," Office of the Inspector General, Department of Health and Human Services, May 2009, www.oig.gov.

Physician On-Call Services

OIG Guidelines for Setting On-Call Compensation Arrangements at *FMV*

- Conduct independent, third party analysis, to determine if arrangement is at *FMV*
- Ensure all physicians are eligible and payment is not based on the volume or value of referrals provided to the hospital
- Ensure equal division of on-call duties among all physicians
- Demonstrate that the hospital has a "*legitimate, unmet need*" for on-call coverage and that compensation will ameliorate the situation
- Avoid payments for "*lost opportunity*" when services are not actually provided

"OIG Advisory Opinion No. 07-10," Office of the Inspector General, Department of Health and Human Services, September 2007, www.oig.gov.
"OIG Advisory Opinion No. 09-05," Office of the Inspector General, Department of Health and Human Services, May 2009, www.oig.gov.

Physician Administrative Services

Assessing *FMV* of Medical Directorships

- Employer should **document** the methodology used to set compensation
- Beneficial for employer to **track *and* document** the actual number of hours the medical director spends performing the services, as well as to make sure the documentation is consistent with the hours outlined in the medical director agreement
- ***"Justifying the need for medical director services goes hand-in-hand with showing that the services are actually furnished."***

"Fair Market Value Support Required: Physicians in Administrative Roles," By Jen Johnson, American Health Lawyers Association, Articles and Analyses, June 2008.
"Health Care Fraud and Abuse: Practical Perspectives" Linda A. Baumann, The American Bar Association & The Bureau of National Affairs, Inc., Washington, DC (2002), p. 281.

Questions & Answers