

THE NEW AGE OF COMPLEX BUSINESS VALUATION

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KARIN CHERNOFF KAPLAN, AVA
DGA PARTNERS
THOMAS M. TAMMANY, ESQUIRE
BUCHANAN INGERSOLL & ROONEY PC

AGENDA

- > Market Forces and Drivers of Physician-Hospital Transactions
- > FMV Legal Concepts
- > Basic Valuation Principles
- > Business Models and Case Studies

HEALTH REFORM AT ITS SIMPLEST

(At Least the Goals)

- > Better Care for Individuals
- > Better Health for Populations
- > Lower Cost per Capita

REFORM OR NOT, HEALTH CARE IS TRANSFORMING

- > Hospital employment of physicians
 - Employed but often not yet integrated at hospitals
 - > Compensation design is critical
 - > Struggling to engage employed physicians
 - > EHRs may help
 - Hospital challenge: Living with a mix of employed and independent physicians, and a variety of integration models
 - > Must still engage independent physicians
 - > Some powerful physician groups
- > A push for value and quality

WHAT IS DRIVING US NOW?

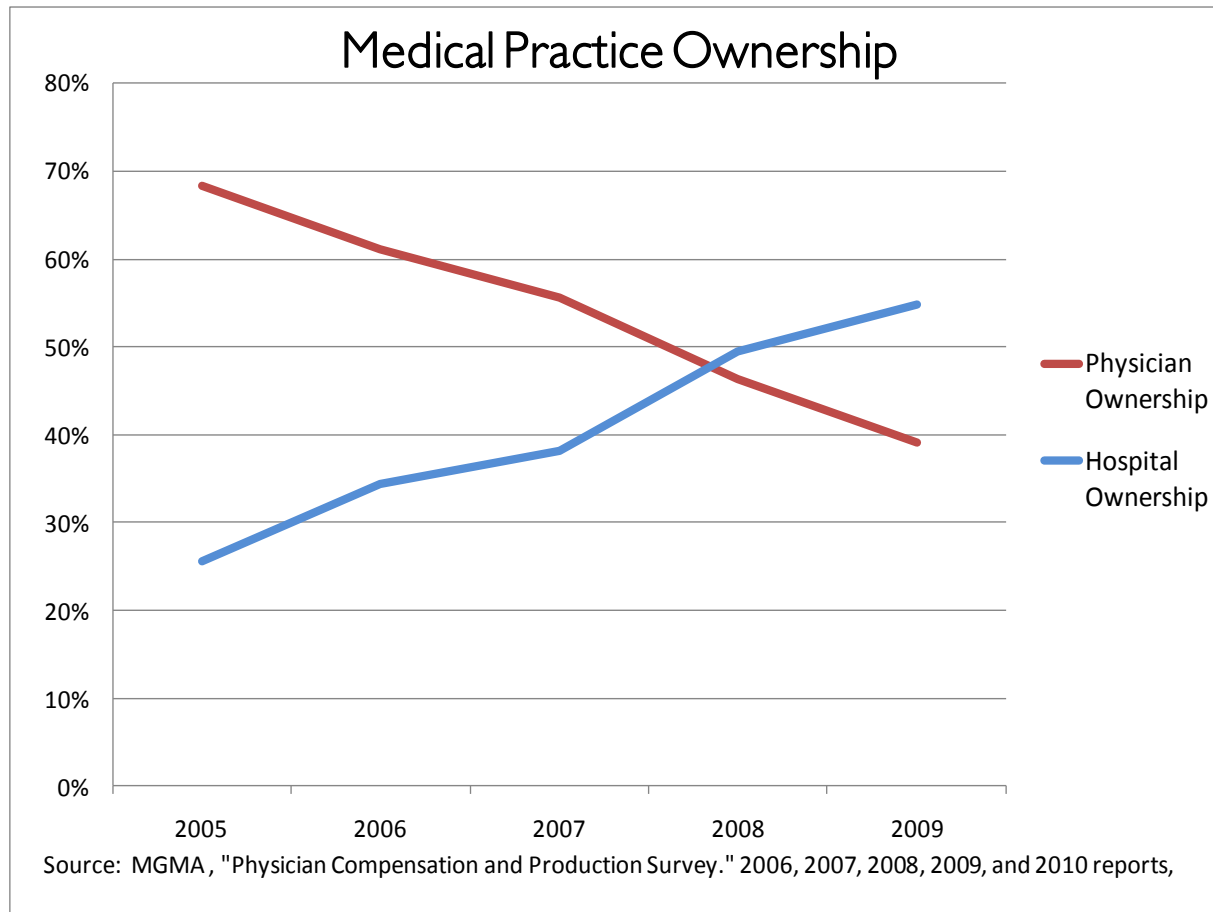
PHYSICIANS

- > Flat or declining reimbursement
- > High malpractice costs
- > Increased regulatory/payer/IT burdens
- > Working hard, earning less
- > Need for succession
- > New graduates want lifestyle and security

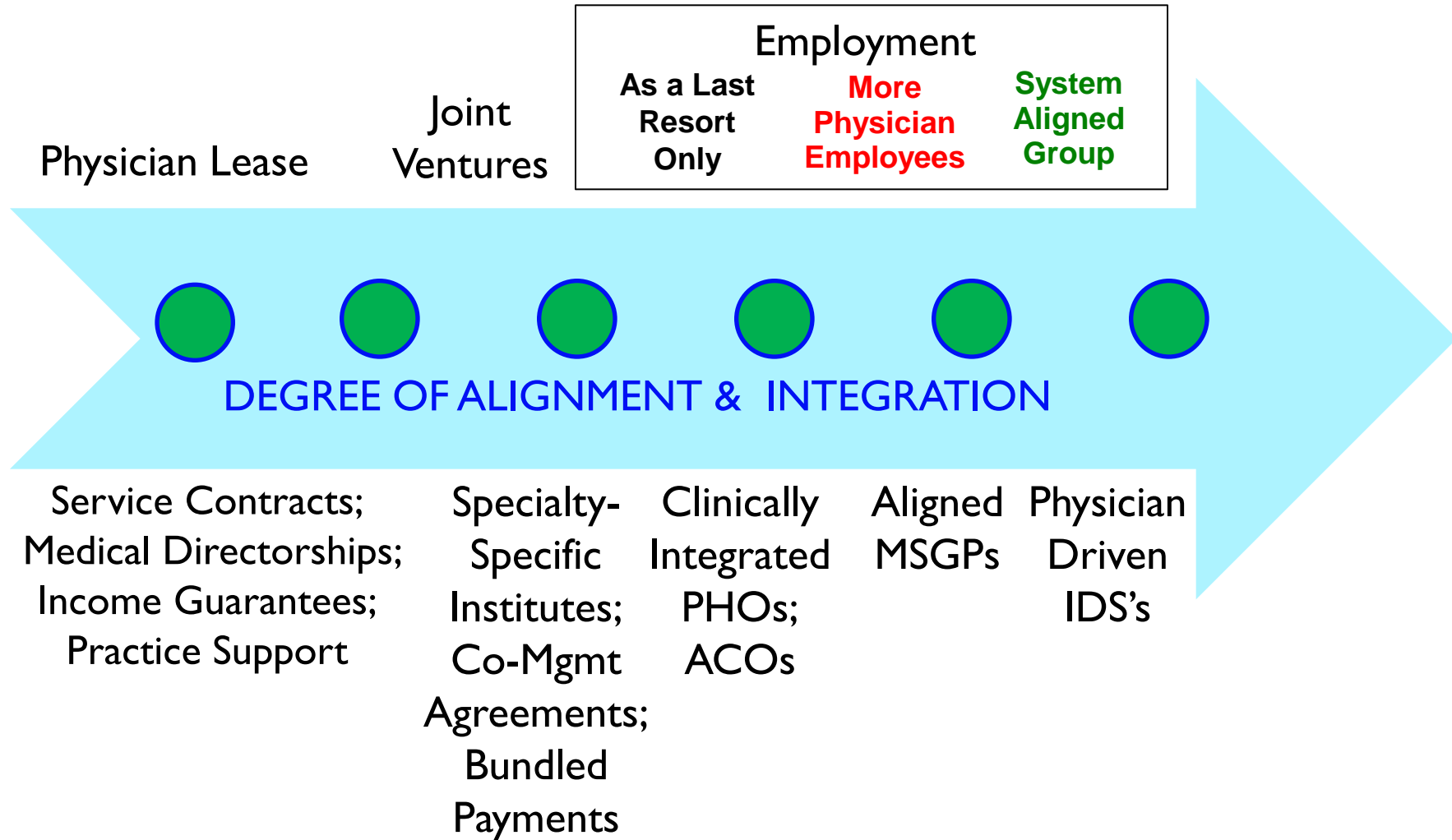
PROVIDER ORGANIZATIONS

- > Secure/grow medical staff
- > Respond to specific market opportunities
- > Strengthen quality of care
- > Protect high margin services
- > Meet coverage requirements
- > Prepare for payment innovations

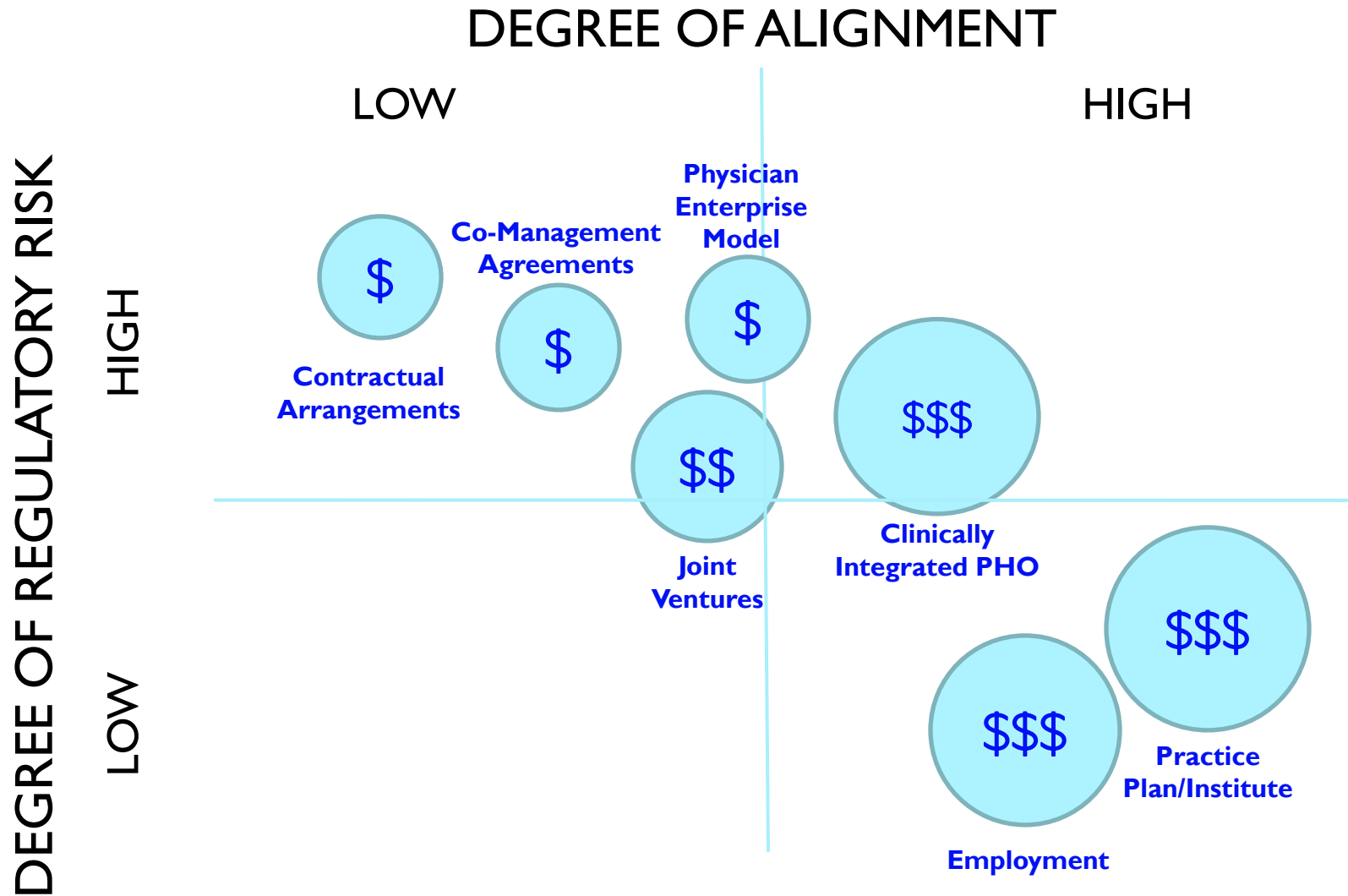
MORE PHYSICIANS ARE JOINING HOSPITALS AND HEALTH SYSTEMS RATHER THAN GOING INTO PRIVATE PRACTICES



A PROLIFERATION OF MODELS HAS EVOLVED



ALIGNMENT, RISK AND COST



Modern Healthcare

THE ONLY HEALTHCARE BUSINESS NEWS WEEKLY

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FEDERAL FRAUD INVESTIGATIONS, SETTLEMENTS RAIN DOWN ON HEALTHCARE

ALIGNMENT VS. ARRAIGNMENT



FEDERAL STATUTES AND REGULATIONS PREVIOUSLY ENACTED TO FIGHT FRAUD AND ABUSE IN HEALTH CARE

- > Anti-Kickback Statute of the Social Security Act (SSA) and Regulations
- > The Ethics in Patient Referrals Act and Regulations (the “Stark” Law)
- > Civil Monetary Penalty Statute
- > False Claims Act and the Fraud Enforcement and Recovery Act of 2009
- > Internal Revenue Service 501(c)(3) Not-For-Profit Requirements
- > Health Insurance Portability and Accountability Act of 1996

STARK EXCEPTIONS UNDER THAT CONTAIN VALUATION LANGUAGE

- > Bona fide Employment Relationships
- > Rental of Office Space
- > Rental of Equipment
- > Personal Service Arrangements
- > Isolated Transactions
- > Group Practice Arrangements with Hospitals
- > Payments by a Physician
- > Fair Market Value Compensation
- > Indirect Compensation Arrangements

STARK LAW DEFINITION OF FMV

- > **“Fair Market Value”** is defined as **“the value in arms length transactions, consistent with the general market value”** (i.e., the price or compensation arrived at by *bona fide* bargaining between well-informed parties who are not otherwise in a position to generate business for the other party), and, with respect to rentals or leases, the value of rental property for general commercial purposes (not taking into account its intended use) and, in the case of a lease of space, **not adjusted “to reflect the additional value the prospective lessee or lessor would attribute to the proximity or convenience to the lessor where the lessor is a potential source of patient referrals to the lessee.”**

ANTI-KICKBACK SAFE HARBORS THAT REQUIRE “FMV”

- > Investment Interests
- > Space Rental
- > Equipment Rental
- > Personal Services and Management Contracts
- > Increased coverage, reduced cost-sharing amounts, or reduced premium amounts offered by health plans
- > Ambulatory Surgery Centers
- > Price reductions offered by contractors with substantial financial risk to managed care organizations
- > Ambulance Replenishing

OIG AND FAIR MARKET VALUE

- > OIG produces various kinds of statements and information
 - o Do not have the force of law
 - o Indicate practices that are of particular concern to the OIG
 - o Indicate the OIG's internal positions on various matters falling within the scope of Anti-Kickback Statute
- > OIG issues advisory opinions in response to individuals who submit proposed arrangements review and also “compliance guidance” that discuss certain arrangements that OIG believes may pose a more significant threat for fraud and abuse.
 - o Not precedence that can be relied upon by unrelated parties
 - o “Standard of care” to which the OIG will likely hold a health care provider to with respect to the topic(s) addressed in the guidance

IRS NON-PROFIT STATUS

PRIVATE INUREMENT

- > An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals who have a personal and private interest in the activities of the organization.

COMMERCIAL REASONABLENESS FOR IRS PURPOSES

- > A compensation arrangement will not constitute prohibited private inurement if the entire compensation is found to be reasonable relative to the services provided to the exempt organization. Specific factors consider:
 - o Negotiated at arms length;
 - o Specialized training and experience of the physician;
 - o Size of the organization;
 - o Nature of duties performed, time spent performing duties & the amount of responsibility;
 - o The physician's contribution to profits;
 - o National and local economic conditions;
 - o Time of year when compensation is determined;
 - o Whether the compensation is in part or in whole payment for a business or assets;
 - o Salary ranges for equally qualified physicians in comparable organizations; and
 - o Independence of the board or committee that determines the compensation.

VALUATION STANDARDS

- > *Fair Market Value* – Hypothetical buyer and seller, arms length, open market
- > *Strategic Value* – The value to a particular investor based on individual investments requirements and expectations. Takes into account strategic or synergistic impact of transaction

PREMISE OF VALUE

- > **Book Value** – not an appropriate measure of business value. Difference between book value of company's assets and liabilities
- > **Going Concern Value** – Value of a business that is expected to continue to operate into the future
- > **Liquidation Value** (Orderly or Forced) – Value at which assets are sold as quickly as possible – business will not continue to operate
- > **Replacement Value** – Refers to the current cost of a similar new property having the nearest equivalent utility

VALUATION STANDARD APPROACHES

> Income Approach

- DCF Method
- Capitalized Earnings
- Assumptions, growth rates, discounts , control, discount rate

> Market Approach

- Market comparables
- Guideline company

> Cost Approach

- Cost to build approach

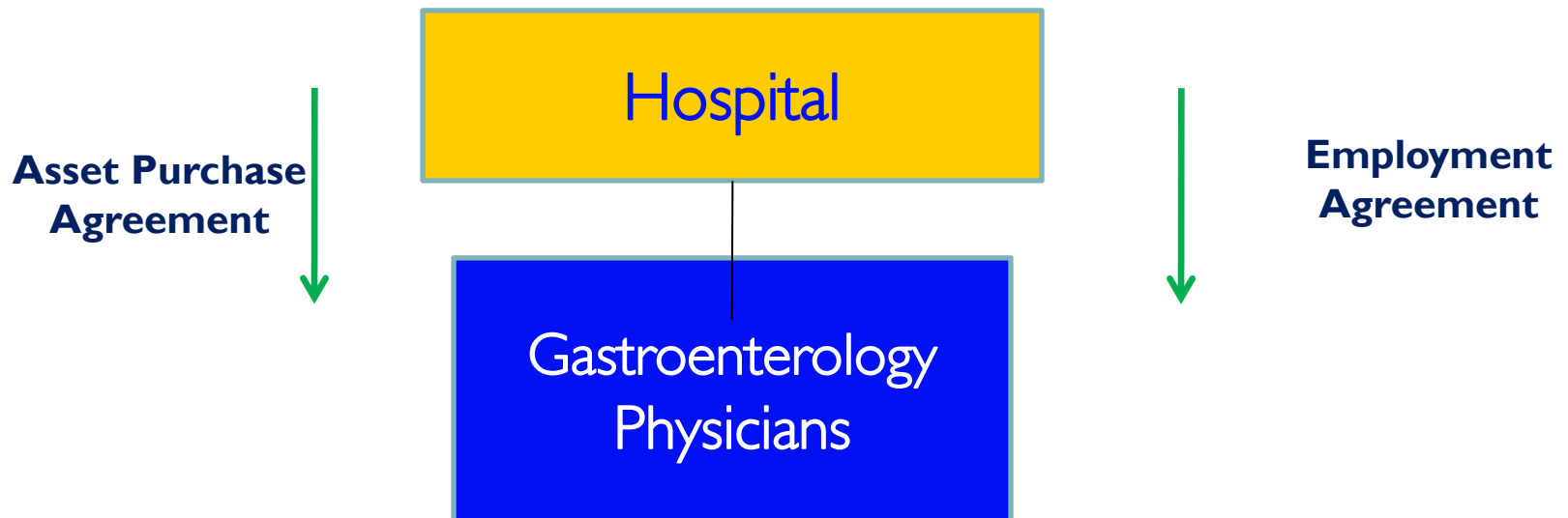
APPROACHES AND SUBJECTS

- > All three approaches should be *considered* when assessing FMV
- > Not all approaches are applicable
- > Business Valuations: review all three
- > Compensation: usually market approach
- > Ventures, services: usually mix of market and cost approaches

Recent Case Law Addressing Fair Market Valuation -- *U.S. ex rel. Singh v. Bradford Regional Medical Center*

- > In response to physician group's acquisition of certain nuclear imaging equipment, Hospital entered into sublease with physician group for the use of the nuclear imaging equipment for Hospital patients (included non-compete in favor of hospital).
- > FMV analysis specifically compared the revenues the Hospital expected to generate with the sublease & non-compete in place to the revenues the Hospital expected to receive without the sublease & non-compete in place ... based on the expectation that the physician group would refer such business to the Hospital if the sublease arrangement was approved.
- > Therefore, the court concluded that the aggregate compensation (fixed monthly fees) took into account the anticipated volume or value of referrals to be generated by the referring physicians for the hospital; and, thus, ***was not FMV for the purposes of the Stark Law.***

TRADITIONAL EMPLOYMENT



> Optimal situation (vis a vis integration):

- Popular for primary care physicians; trend is increasing for specialists as well
- Fulfill a community need that is not otherwise met by physicians on medical staff
- Lower regulatory burden and scrutiny than other models

COMPENSATING EMPLOYED PHYSICIANS

- > Compensation models typically consist of some or all of the following elements:
 - o Base Guaranteed Compensation
 - o Productivity Incentive
 - > Based on wRVUs or collections
 - o Quality and Performance Incentive
 - o Expense Management Incentive
 - o Compensation for Administration, Supervision and Teaching (AS&T)

EMPLOYMENT OF TWO GASTROENTEROLOGISTS

- > Base Clinical Compensation: \$360,000 per physician
- > Productivity Incentive Bonus: Bonus compensation based on individual Group productivity. Payment per Excess wRVU is set at the median benchmark of \$41.15 per wRVU
- > Potential quality incentive of \$24,000 based on physicians meeting or exceeding the minimum expectations outlined in the physicians' goals and objectives.
- > AS&T Compensation – Dr.A will be compensated \$100,000 per year for Chairman duties 8 hours per week

FMV ANALYSIS - BASED ON GASTROENTEROLOGY BENCHMARKS

Percentile Benchmark ⁽²⁾	WRVU ⁽³⁾ (1.0 FTE)	Compensation (1.0 FTE)	Compensation (Hourly) ⁽⁴⁾
50th%:	7,735	\$ 425,571	\$ 205
60th%:	8,747	\$ 490,320	\$ 236
75th%:	9,759	\$ 555,069	\$ 267
90th%:	11,764	\$ 680,261	\$ 327

1) Blend of three published surveys (MGMA, SCA, AMGA)

Proposed Clinical Compensation Compared to Actual Productivity

Physician	2010 Annualized WRVUs (1)	WRVU Benchmark Range	Estimated Total Clinical Compensation (2) (based on actual wRVUs)	Clinical Compensation Benchmark Range
1	12,431	Above 90th Percentile	\$ 490,106	60th-75th percentile
2	12,412	Above 90th Percentile	\$ 490,885	60th-75th percentile
Average Per Physician	12,421	Above 90th Percentile	\$ 490,496	60th-75th percentile

> Even with addition of full quality incentive, compensation below benchmark

FMV ANALYSIS

> Proposed AS&T compensation just over the 60th percentile, consistent with training, experience and market

AS&T FTE	Proposed AS&T Compensation	FTE-adjusted 50th percentile Benchmark	FTE-adjusted 60th percentile Benchmark (1)	FTE-adjusted 75th percentile Benchmark
0.20	\$100,000	\$ 85,114	\$ 98,064	\$ 111,014

LEGAL CONSIDERATIONS - EMPLOYMENT

- > Stark Employee Exception
- > Anti-Kickback Safe Harbor
 - o Must be bona fide employment relationship (no FMV requirement)
 - o For part-time employment, see OIG Advisory Opinion 08-22
- > Tax Exemption Issues (Private Inurement / Private Benefit)
- > State corporate practice of medicine laws
- > Relevant Case Example – *U.S. ex rel. Drakeford v. Tuomey*

STARK LAW – BONA FIDE EMPLOYMENT EXCEPTION

- > *Bona fide employment relationships.* Any amount paid by an employer to a physician (or immediate family member) who has a *bona fide* employment relationship with the employer for the provision of services if the following conditions are met:
 - o The employment is for identifiable services.
 - o The amount of the remuneration under the employment is:
 - > Consistent with the FMV of the services; and
 - > Except as provided below, is not determined in a manner that takes into account (directly or indirectly) the volume or value of any referrals by the referring physician.
 - o The remuneration is provided under an agreement that would be commercially reasonable even if no referrals were made to the employer.
 - o The above restriction on remuneration taking into account volume or value of referrals, does not prohibit payment of remuneration in the form of a productivity bonus based on services performed personally by the physician (or immediate family member of the physician).

Recent Case Law Addressing Employment

Arrangements - *U.S. ex rel. Drakeford v. Tuomey*

- > Tuomey Health System ("Tuomey"), a non-profit corporation which operated Tuomey Hospital, entered into part-time employment agreements with 19 physicians to perform outpatient procedures at the Hospital, exclusive for 10 year terms, with an additional 2 year non-compete post-termination in favor of the Hospital.
 - o Employment arrangements were allegedly in response to a threat of certain physicians redirecting outpatient procedures from Hospital to a physician-owned ambulatory surgery center.
 - o Considered indirect compensation arrangements because Tuomey created for-profit entity to own four limited liability companies which employed the physicians.

Recent Case Law Addressing Employment Arrangements - *U.S. ex rel. Drakeford v. Tuomey*

- > Physicians received a base salary, productivity bonuses based upon collections and an incentive bonus for meeting certain quality goals.
- > Government alleged that:
 - o Employment agreements provided that Tuomey collected each physician's professional fees from Medicare, other insurers and patients, and then paid the physicians a base salary tied to their collections, plus a "productivity bonus" totaling 80% of their collections, and up to an additional 5.6% of their collections for meeting certain quality measures. Thus, ***each time a physician performed an outpatient procedure on a Medicare beneficiary, the physician received increased compensation from Tuomey and the hospital received a corresponding referral of the technical component of each procedure, for which it could bill Medicare for a facility fee.*** Because of this one-to-one relationship, the compensation, by design, varied with the volume or value of the physicians' referrals; and
 - o FMV analysis also took into account the volume or value of referrals, because the analysis included consideration of the "net present value of the non-compete clause" by calculating the value of each physician group's outpatient referrals that Tuomey feared losing and wanted to keep, dividing that figure by the number of physicians in the group, and using the resulting amount as a "benchmark" for determining each physician's total compensation.
- > Ultimately, jury found that the compensation arrangements / employment agreements violated the Stark Law and district court ordered Tuomey to repay the government nearly **\$45 million dollars. Tuomey's appeal remains pending.**

THE CARDIOLOGY ACQUISITION DEAL



Acquires
Cardiology
Practice



- > Purchase price based on valuation of practice assets; tangible and identifiable intangible assets
 - o Income approach not relevant due to lack of positive cash flow
 - o Valuation of assets based on cost approach
 - o Diagnostic services become hospital based (assuming licensure requirements met)

CARDIAC PRACTICE PROFILE

- > Four physician practice
- > Total Practice global revenue \$4.1 million
 - o \$1.4 Technical
 - o \$2.7 Professional
- > Hospital estimate of ~250 percent increase in technical revenue due to relicensure
- > **Reimbursement impact not considered in valuation.**
- > Payer specific and market dependent.

VALUE CONCLUSION CARDIOLOGY PRACTICE

Cardiology Practice Asset Approach Summary

Tangible Assets:

Furniture and Equipment	\$103,000
Leasehold Improvements	\$4,000
Inventory	\$25,000

Identifiable Intangible Assets:

Workforce in Place - Staff	179,000
Cost to Populate EMR	100,320
Telephone Number and Name Recognition	<u>\$33,000</u>
Total	\$ 444,320

FMV CONSIDERATIONS PRACTICE ACQUISITIONS

- > The estimate of the practice income stream is directly related to the future stability of the patient base
- > Non-compete is implicit and key to value
- > If purchase price included intangible value, future compensation cannot be ignored; must be FMV
- > Equity vs. total asset acquisition
- > Strategic Value vs. FMV

FMV CONSIDERATIONS PRACTICE ACQUISITIONS

- > Get the revenue right!
 - o Global vs. “facility only”
 - o Announced rate changes
 - o Planned and committed physician departures and recruits

- > Equipment
 - o Replacement factor
 - o Out of date

- > Poor acquisition sales data (comparable sales)

LEGAL CONSIDERATIONS-PRACTICE ACQUISITIONS

- > Stark Isolated Transactions Exception
- > No Applicable Anti-Kickback Statute Safe Harbor
 - o Only applies to practice acquisitions of physicians practices in a Health Professional Shortage Area, where the physician will no longer be in a position to refer to the purchasing entity.
 - o Thornton Letters – payments for items other than hard assets (i.e., intangible assets) are subject to scrutiny under the Anti-Kickback Statute. See also OIG Advisory Opinion, 09-09 (valuation of only “tangible assets”)
- > Tax Exemption Issues
 - o Tangible Assets vs. Intangible Assets (Payment for Goodwill)
 - > IRS CPE guidance on valuation of medical practices acquired by tax-exempt hospitals
 - > Revenue Ruling 59-60 (valuing stock of closely held corporations)
- > Relevant Case Example – U.S. ex rel. Obert-Hong v. Advocate Health Care

Recent Case Law Addressing Employment

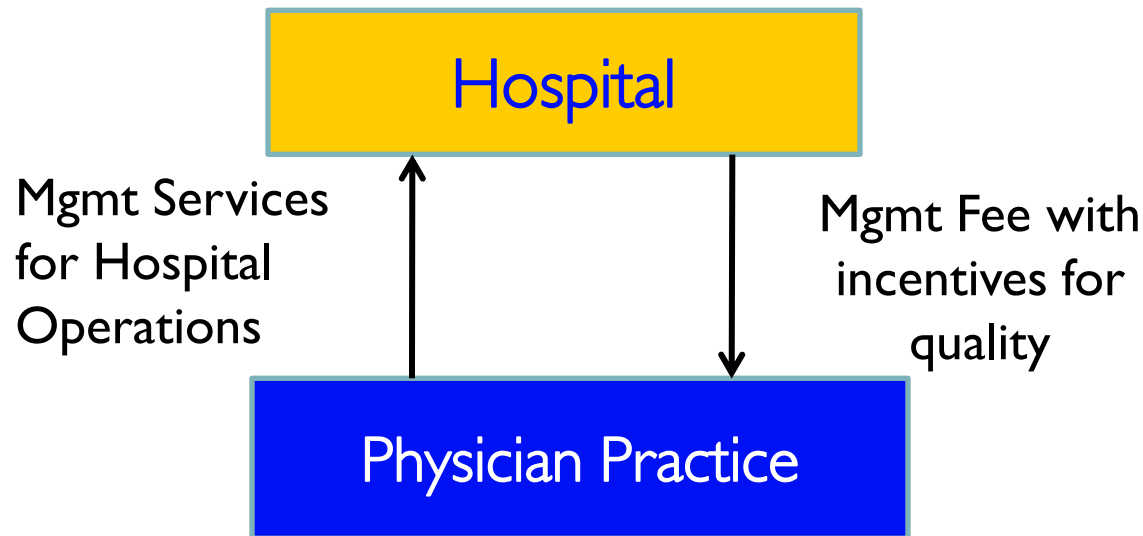
Arrangements - U.S. ex rel. Obert-Hong v. Advocate Health Care

- > Whistleblower case alleging violations of FCA, Stark Law and Anti-Kickback Statute due to allegations that for-profit health care provider and hospital subsidiary paid **commercially unreasonable amounts** to acquire practices, employed doctors via contracts mandating referrals to the hospital subsidiary and paid physicians a percentage of collections for referred patients.
 - o Court noted that practice acquisitions implicate the Anti-kickback Statute; however, to comply “hospital must simply pay fair market value for the practice’s assets”
 - o FMV “may differ from traditional economic valuation formulae. Normally, we would expect the acquisition price to account for potential revenues from future referrals. Because the Anti-Kickback Act prohibits any inducement for those referrals, however, they must be excluded from any calculation of fair value here”
 - > However, whistleblower failed to particularly allege why compensation was not commercially reasonable.

Recent Case Law Addressing Employment Arrangements - U.S. ex rel. Obert-Hong v. Advocate Health Care

- Court further noted that practice acquisitions implicate the Stark Law; however the purchase of a physician practice is a “quintessential example” of a transaction qualifying for the Stark exception for isolated transactions
 - Nevertheless, whistleblower failed allege any facts demonstrating that the arrangement did not qualify for the isolated transaction exception.
- Finally, with respect to the post-acquisition employment contracts, the court concluded that:
 - The only financial relationship between the defendants and physicians fell within the bona fide employee exceptions and there is nothing in either the Stark Law or Anti-Kickback Statute “that prohibits hospitals from requiring that employee physicians refer patients to that hospital.”
 - Further, because the percentage compensation was based on personally performed services, the arrangements qualified for the Stark Law employee exception, which specifically permits productivity bonuses for services personally performed by the doctor and all compensation paid to the physicians was deemed to fall within the Anti-Kickback Statute's employee safe harbor.

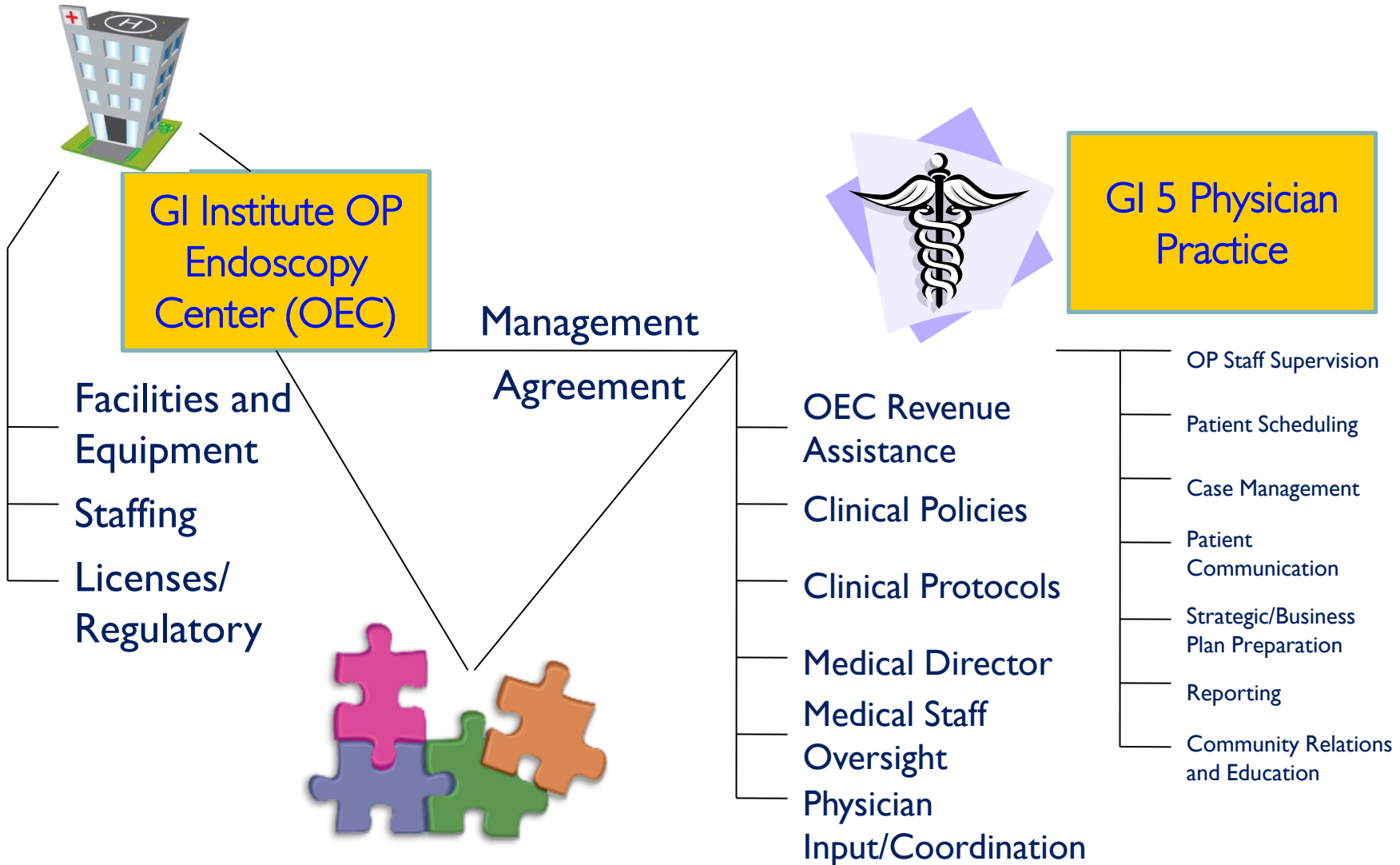
CO-MANAGEMENT AGREEMENTS



> Optimal Situation

- o Large single specialty group with majority of hospital volume for that specialty

THE GI CO-MANAGEMENT DEAL



GI CO-MANAGEMENT CHALLENGES

- > Delineating specific responsibilities
- > Determining FMV of management services
 - o Work effort
- > Defining quality metrics
- > Determine FMV of quality payment
- > Term of agreement

GI CO-MANAGEMENT FMV SUMMARY

Manager and Administrative Services
Time Requirements and Total Compensation

	2009
Estimated Hours Worked	
Physician ¹	890
Admin. ²	390
Clerical ³	5,460
Hourly Compensation	
Physician	\$ 256
Admin.	\$ 62
Clerical	\$ 16
Estimated Total Hourly Based Compensation	
Physician	\$227,506
Admin.	\$24,000
Clerical	\$86,934
Subtotal	\$338,440
Benefits	\$ 91,379
Overhead	\$ 7,112
Estimated Total Compensation	\$436,931

GI CO-MANAGEMENT ANNUAL PERFORMANCE INCENTIVE

- > Patient Satisfaction - 25% of total Performance Incentive
 - Maintaining an overall endoscopy suite patient satisfaction level, based on Press Ganey questionnaire, that meets or exceeds ninety percent (90%).

- > Clinical Quality – 75% of total Performance Incentive
 - Four clinical goals per year identified
 - Each annual clinical performance goal supported by objective, scientific evidence with quarterly, quantifiable goals for measuring achievement

GI CO-MANAGEMENT ANNUAL PERFORMANCE INCENTIVE

Quality Incentive Analysis				
Estimate	FY 2010 Total Revenue	Quality Incentive Pool	Co-Management Share	Total Bonus
Low Range	\$ 9,277,203	2%	50%	\$ 92,772
High Range		4%		\$ 185,544

GI CO-MANAGEMENT ANNUAL PERFORMANCE INCENTIVE

Total Co-Management Payments - GI			
	Management Services	Total Potential Quality Incentive	Total Potential Compensation
Compensation	\$ 436,931	\$ 165,000	\$ 601,931

LEGAL CONSIDERATIONS CO-MANAGEMENT AGREEMENTS

- > Stark Law Exception (Personal Service Arrangements)
 - o Fair Market Value Compensation, Personal Service Arrangements, Indirect Compensation Arrangements
 - o Proposed P4P (16 Req'ts)
 - o Stark Phase III Regulations – CMS distinction between clinical & administrative services 72 Fed. Reg. 51012, at 51016 (September 5, 2007) (“fair market value of administrative services may differ from the fair market value of clinical services”)
- > Anti-Kickback Personal Services and Management Contracts Safe Harbor
- > Tax Exemption Issues (Private Inurement / Private Benefit)
- > CMP Law — Incentive payment cannot encourage physicians to reduce or limit clinical services to Medicare / Medicaid beneficiaries
- > Relevant Case Example - *U.S. ex. Rel. Kosenske v. Carlisle HMA, Inc.*

Recent Case Law Addressing Exclusive Management Arrangement - *U.S. ex. Rel. Kosenske v. Carlisle HMA, Inc.*

- > Recent whistleblower case brought by former member of anesthesia group (3rd Circuit)
 - > Exclusive anesthesia provider / management agreement signed in 1992
 - > Hospital built new stand-alone facility 3 miles from campus containing an ASF and pain clinic in 1998
 - > Anesthesia Group provided pain management services at pain clinic and hospital provided space, equipment and staff for free
 - > Physicians billed for professional services and hospital billed facility and technical components
 - > 1992 contract was not updated or amended to include these services
 - > In 2005, Plaintiff left the group and successfully filed suit alleging violations of Stark and Anti-Kickback Statute

Recent Case Law Addressing Exclusive Management Arrangement - *U.S. ex. Rel. Kosenske v. Carlisle HMA*

- > Free rent, equipment and personnel was remuneration in-kind and evidenced financial relationship arrangement under Stark
- > No written agreement memorializing pain management services, which were substantively different from inpatient anesthesia services described in 1992 contract
- > Even if 1992 contract applied to the pain management, it did not specify the compensation to be paid over term, as required by personal services exception to Stark
- > Court reasoned that pain management clientele could be referred to hospital

Recent Case Law Addressing Exclusive Management Arrangement - *U.S. ex. Rel. Kosenske v. Carlisle HMA*

> Lessons to be learned from *Kosenske*

- Financial relationships of any kind between hospitals and physicians should be reflected in a written agreement
- Keep your documentation and contracts current
- Supplying space, equipment and personnel by hospital to its hospital-based service provider is not *per se* illegal; the value of these components must be factored into analysis of whether overall arrangement is consistent with FMV

OTHER CONTRACTUAL ARRANGEMENTS



Service Contracts
Medical Directorships
Income Guarantees
Practice Support
Call Coverage

