

Conceptualizing Fair Market Value in Compensation Arrangements

Health Care Compliance Association
Physician Practice Compliance Conference

San Francisco, California
September 9, 2005



Gregory D. Anderson, CPA, CVA
Partner, Health Care Services



Conceptualizing Fair Market Value in Compensation Arrangements

- **Defining Fair Market Value**
- **Fair Market Value from a Health Care Regulatory Perspective**
- **Key Appraisal Concepts**
- **Application to Contractual Arrangements**

Defining Fair Market Value

Fair Market Value Theory

Definition of FMV

1. Internal Revenue Service

- “The amount at which a property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.”

2. Industry definition

- “The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”

Distinction Between FMV and Other Standards of Value

➤ Key differences in standards of value

- Fair market value
- Fair value
- Investment value
- Other standards of value
 - Intrinsic value
 - Liquidation value
 - Use value

Tabular Comparison of Key Concepts

| <u>Fair Market Value</u> | <u>Fair Value</u> | <u>Investment Value</u> |
|---|---------------------------------|---|
| Willing buyer | Willing or unwilling buyer | Willing buyer |
| Willing seller | Unwilling seller | Willing seller |
| Neither under compulsion | Seller is under compulsion | Neither under compulsion |
| Hypothetical buyer and seller | Specific buyer and seller | Specific buyer |
| Buyer and seller are both knowledgeable | Seller may not be knowledgeable | Buyer and seller are both knowledgeable |

Fair Market Value from a Health Care Regulatory Perspective



Fair Market Value from a Health Care Regulatory Perspective

➤ Physician self-referral law (Stark law)

- ◆ General prohibition
- ◆ Pervasiveness of FMV in exceptions
- ◆ The Stark definition of FMV
- ◆ FMV safe harbor
 1. ERP method
 2. National survey method

Fair Market Value Safe Harbor Pitfalls

Shortcomings of the ER Physician Market Method

- ◆ The “relevant market”
- ◆ Finding three hospitals willing to share information
- ◆ Ignores wide ranges of compensation among specialties
- ◆ Disregards nuances of shortage specialties

Fair Market Value Safe Harbor Pitfalls, cont'd

Shortcomings of the National Survey Method

- ◆ Not region-specific
- ◆ Limited subspecialty data
- ◆ Low participation
- ◆ Other widely recognized surveys omitted
- ◆ Cost

Fair Market Value Safe Harbor Pitfalls, cont'd

Shortcomings Applicable to Both Methods

- ◆ Both apply only to hourly payments to physicians
- ◆ Neither method addresses aggregate compensation
- ◆ Both are ineffective when community need or physician shortage affects physician recruitment
- ◆ Both methods disregard highly qualified or productive physicians
- ◆ Averages may be skewed by wide disparity of data

January 14 suit filed by Renal Physicians Association against DHHS and CMS

➤ RPA Alleges that the Fair Market Value Safe Harbor will:

- ◆ Adversely affect the quality of dialysis patient care
- ◆ Make it difficult for dialysis facilities to recruit individuals with training and experience needed to be effective medical directors

➤ Other RPA Allegations:

- ◆ HHS failed to follow Administrative Procedures Act
- ◆ Surveys are non-existent, outdated or difficult to obtain

➤ RPA Concerns:

- ◆ Facilities will require the FMVSH, which will become the norm
- ◆ Result in unfair compensation
- ◆ Cause declines in medical director compensation

Federal Anti-Kickback Statute

- **Space Rental**
- **Equipment Rental**

Differences Between Traditional and Regulatory Definitions of FMV

| <u>Traditional Definition</u> | <u>Regulatory Definition</u> | <u>Composite Definition</u> |
|--------------------------------|---|---|
| Hypothetical buyer and seller | | Hypothetical buyer and seller |
| Willing buyer and seller | | Willing buyer and seller |
| Arms-length negotiation | <i>Bona fide</i> bargaining | Arms-length, <i>bona fide</i> negotiations |
| Neither under compulsion | | Neither under compulsion |
| Knowledgeable buyer and seller | Well-informed buyer and seller | Well-informed, knowledgeable buyer and seller |
| | Buyer and seller are not otherwise in a position to generate business for the other | Buyer and seller are not otherwise in a position to generate business for the other |
| | Assets or services of like type, quality And quantity in a particular market | Assets or services of like type, quality and quantity in a particular market |
| | Service agreements contain comparable terms | Service agreements contain comparable terms |

Key Appraisal Concepts

Theoretical Hierarchy of General Appraisal Practice

Cost Approach

Method 1
Method 2
Method 3

Income Approach

Method 1
Method 2
Method 3

Market Approach

Method 1
Method 2
Method 3

Synthesis
and
Reconciliation

Value
Conclusion

Valuation Approaches

- **Three broad approaches**
 - **Cost based approach**
 - **Income based approach**
 - **Market based approach**

Principles of Valuation

- **Three central principles**
 1. **Principle of alternatives**
 2. **Principle of substitution**
 3. **Principle of future benefits**

Application to Contractual Arrangements

Service Arrangements

➤ Examples of service arrangements involving physicians

- ◆ Employment agreements
- ◆ Independent contractor arrangements
- ◆ Medical or program directorship contracts
- ◆ Shared use or cost arrangements
- ◆ Lease arrangements
- ◆ Management service agreements

Comparison of Key FMV Concepts

| <u>Assets or Business Interests</u> | <u>Service Agreements</u> |
|---|--|
| Willingness of buyer and seller | Willingness of purchaser and provider of the goods or services |
| Hypothetical universe of buyer and seller | Hypothetical universe of purchasers and providers of the goods or services |
| Neither under compulsion | Neither under compulsion |
| Buyer and seller are both knowledgeable | Purchaser and provider of the goods or services are both knowledgeable |
| Result of <i>bona fide</i> bargaining | Result of <i>bona fide</i> bargaining |
| Neither buyer nor seller are in a position to generate business for the other party | Neither purchaser nor provider of the goods or services are in a position to generate business for the other party |

The Three Approaches Applied to Service Agreements

▶ **Cost based approach**

1. Concept of income projections

- **Avoided costs**
- **Projections of physician losses**
- **Build-up cost methodology**

2. Buyer's perspective vs. seller's perspective

- **Buyer's make-or-buy decision**
- **Reasonable rate of return**

The Three Approaches Applied to Service Agreements, cont'd

Cost approach

- Per-click arrangements for equipment leases
- Management service (“MSO”) arrangements
- Leasing of personnel
- Leases for purposes of technical component billing
- Valuing inactive certificates of need
- Physician call coverage

The Three Approaches Applied to Service Agreements, cont'd

▶ **Income based approach**

- 1. Principle of future benefits**
- 2. Reimbursement, net of costs, plus return**
- 3. Buyer's perspective vs. seller's perspective**

The Three Approaches Applied to Service Agreements, cont'd

Income approach

- **Physician recruiting and income guarantees**
- **Valuing active licenses or active certificates of need**
- **Per-click arrangements for equipment leases**
- **MSO arrangements**
- **Leases for technical component billing**

The Three Approaches Applied to Service Agreements, cont'd

▶ **Market based approach**

- **Billing and collection of professional and technical component fees and appropriate matching of costs**
- **Simple lease vs. turnkey deal**
- **Tainted transactions**

The Three Approaches Applied to Service Agreements, cont'd

Market approach

- Physician clinical compensation arrangements, including clinical compensation and call coverage
- Administrative (e.g., medical director) compensation arrangements
- Valuing joint ventures, active ancillary services or CON entities
- MSO arrangements
- Comparable per-click arrangements

Synthesis, Reconciliation and Conclusion

Combination or weighting of relevance

Development of floors or ceilings

Reasonableness tests for other methods

Valuation Issues and Risks

- 1. Know the legal constraints**
- 2. Understand the parties to the contract**
- 3. Understand the reimbursement ramifications**
- 4. Work with market data and financial and statistical reports**
- 5. Recognize multiple components of a single contract**
- 6. Consider community need or physician shortages**

Questions, Dialogue and Conclusion

Conceptualizing Fair Market Value in Compensation Arrangements

Health Care Compliance Association
Physician Practice Compliance Conference

San Francisco, California
September 9, 2005



Gregory D. Anderson, CPA, CVA
Partner, Health Care Services

