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# Buying, Selling, Merging and Valuation

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**Daryl Johnson**  
Principal, HealthCare Appraisers, Inc.

**Chris E. Rossman**  
Partner, Foley & Lardner LLP



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## Subject Transactions

- Sales/mergers of practices
- Chemo infusion under arrangements
- Co-management arrangements
- “Per click” arrangements (e.g., stereotactic radiosurgery JVs)

## The Valuator's Role -

- To consider the commercial reasonableness and the FMV of a proposed transaction as an independent party, taking guidance from valuation theory, the healthcare regulatory environment, the valuator's experience and specific guidance from counsel
- A valuator should not be an advocate for a transaction, but...
- The valuator should not purposefully impart conservative to his/her analysis

## General FMV Issues

- FMV vs. Investment Value
- Commercial Reasonableness
- Valuation Methodologies
  - “Tainted” Market Values
  - “Top Down” Approaches
  - Opportunity Cost Approach

## FMV vs. Investment Value

- The *fair market value standard* is a hypothetical willing buyer/willing seller scenario. No consideration is given to any unique attributes or synergies of either party in reaching a determination of value
- The *investment value standard* takes into consideration the unique synergies or attributes that one or both parties may possess
  - For example, if a hospital has more favorable reimbursement that will enhance the profitability of infusion services being considered for purchase by the hospital, any valuation consideration of this benefit would reflect *investment value*, and not FMV
  - At what point does a stock acquisition of a physician practice invoke *investment value*?

## FMV vs. Investment Value (cont'd)

- While FMV is the applicable valuation standard for most healthcare transactions, *commercial reasonableness* may dictate a departure from the strict FMV definition. For example, if a hospital has purchasing economies related to pharmaceuticals and supplies, any arrangement involving the hospital's acquisition of these items through an agreement with physicians should give consideration to the hospital's actual cost (which invokes *investment value*)

## Commercial Reasonableness

- Commercial reasonableness and FMV must go hand in hand
- An independent valuator should opine with respect to FMV and commercial reasonableness

## Examples of arrangements that may be consistent with FMV, but *not* commercially reasonable -

- A physician group leases employees from a hospital so that the group can enter into a “turn key” service arrangement with the hospital
- A hospital enters into a one-year lease of physician-owned equipment at a “short-term rate premium,” but the lease continues to renew year after year
- The “flip” of an existing entity / service line into an “under-arrangement” structure where little changes (other than the physicians’ access to higher reimbursements)
- A physician group leases to a hospital equipment which the hospital reasonably should own

## Valuation Methodologies

- The following generally accepted valuation approaches can be used for valuing “per click” and other types of businesses/arrangements:
  - Income Approach
  - Cost Approach
  - Market Approach

## Income Approach

- The use of an income approach in evaluating healthcare transactions may appear to give consideration to the value of possible referrals among the parties

## Market Approach

- A Market Approach may not be suited for valuing oncology transactions due to the lack of comparability from one arrangement to the next
- *For example, the following may be different –*
  - The type and cost of equipment involved
  - The specific services which are included in the arrangement
  - Procedure volume

## “Tainted” Market Values

- In addition to healthcare regulations, general valuation theory requires the use of “arms length” market transaction data. Healthcare transactions are frequently suspect
- A market approach is the preferred valuation approach for many types of compensation arrangements
- For certain types of arrangements, virtually no “non-tainted” data is available
  - On-call arrangements
  - Medical directorships
- The valuator must consider alternate approaches
  - Consider analysis of physician compensation data
  - Consider reimbursement rates from Medicare and commercial payors
  - Consider whether the arrangement can be “cross walked” to a non-healthcare setting

## “Top Down” Approaches

- “Non-traditional” *under arrangement* agreements are emerging related to outpatient surgical departments, cath labs, infusion services and other hospital services
- A “top down” approach “passes through” all of the hospital's reimbursement, less a portion retained by hospital related to billing, collections, and other hospital services
- This approach leaves open significant opportunity for challenge.
  - The *actual services* provided by the under arrangement entity must be FMV, and the valuation approach should primarily consider the value of such services
  - The level of reimbursement received by a hospital may have no bearing on the FMV of the services
  - Consider a “crosswalk” to non-healthcare scenarios

## “Opportunity Cost” Approach

- Take caution! In fact, Stark III says...opportunity cost (*i.e.*, the value of his/her clinical services) *may not* be an indicator of the value of a physician’s administrative time
- This position is logical and consistent with the general definition of FMV (*i.e.*, a willing buyer/willing scenario). Doesn’t opportunity cost invoke the *investment value* standard?
- RBRVS specifically identifies that certain physician duties carry a higher relative worth than others. (Otherwise, the “physician work” component of RVUs would be time-based)
- Opportunity cost can be considered, along with market data related to administrative services and informed judgment as to relevant worth of one activity compared to another
- Stark Phase III’s elimination of the FMV safe harbor arguably provides additional flexibility. The safe harbor values were unreasonably low in many situations, but also caused the added concern of not meeting a safe harbor

## Cost Approach

- A Cost Approach can be used considering:
  - The exact services that will be provided
  - A “target” operating margin derived from market sources
  - Consideration should be given to the economic outcomes in relationship to the respective risks assumed

## Sales/Mergers of Practices

- The days of the PPM deals are gone
- Most practice acquisitions today are based upon tangible assets
- Certain identifiable tangible assets are subject to valuation and sale
- The use of an Income Approach essentially freezes physicians' post-transaction compensation

## Infusion Under Arrangements

- Relatively new, and not too prevalent
- Hospital revenue may be much higher, but...
- Heed caution regarding the “Top Down” approach

## Co-Management Arrangements

- These arrangements typically involve physician/hospital ventures to manage hospital service lines, with compensation consisting of base and incentive components

## Co-Management Arrangements

- Compliance with FMV is critical for regulatory compliance, but also for the ultimate success of the project
- Available valuation methodologies are limited and somewhat subjective
- In considering the primary valuation approaches (cost, income and market), an income approach can likely be eliminated
- Using a cost approach, FMV of the management fee can be established by assessing the required number of work hours needed to provide the management services multiplied by a fair market value hourly rate
  - However, the exact number of required work hours cannot reasonably be determined in advance
  - Further, a key ideal of most co-management arrangements is to reward results rather than time-based efforts

## Co-Management Arrangements

- A market approach recognizes that each co-management arrangement is unique, and reflects specific market and operational factors which are singular to the specific setting
  - Break the specific services down into specific tasks and objectives, and then compare to other arrangements
  - On an item specific basis, assess the relative worth of each task/objective, and determine necessary adjustments to the comparable arrangements
- The cost and market valuation methodologies described above must be reconciled to arrive at a final conclusion of value
- The FMV of the *total management fee* must be established, as well as the *base* and *incentive* components

## “Per Click” Arrangements e.g., Stereotactic JVs

- Commercial reasonableness is paramount
- Iffy “per click” arrangements may cast a shadow on all “per clicks” transactions
- Uncertainty with respect to “normal” or projected volumes presents valuation challenges (particularly in the context of a new service)
- Consider the possibility of (i) a *descending* payment structure; (ii) a fixed fee plus a per click; and/or (iii) a payment “cap” to avoid windfall payments should volume escalate
- Consider how FMV may be reassessed after the initial year(s)

## Factors that Support the Commercial Reasonableness of Stereotactic JVs

- The technology is relatively new, expensive and complex
- A limited number of procedures are expected to be performed each year
- The parties to the JV each bear substantial risk
- A hospital reasonably might be disinclined to offer these services without commitment from participating physicians



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## Intent of Payments

- Payment for goodwill, other intangibles (e.g., covenants not to compete, assembled work force, patient lists, patient records, or exclusive dealing arrangements)
  - Raises questions of compliance with the anti-kickback statute
  - Are payments really intended to induce physicians to steer referrals?

## Relevance of Fair Market Value to Intent

- Payments may be appropriate
  - If amount paid is not in excess of the fair market value (without regard to the value of existing or future referrals from the seller to the buyer)
- Value of intangibles should be determined by an independent valuator or appraiser using recognized valuation methodologies based on reasonable economic and market assumptions

## Appropriate Role of Valuation

- Questions raised by purchase by physicians of an interest in an existing provider
  - If valued on an income basis, using future revenues, future referrals by physician investors might increase the purchase price paid by investors
  - Flips anti-kickback analysis on its ear
  - Also brings other factors into play

## Purpose or Remuneration – Role of Fair Market Value Determination

- Chief concern of regulators: Is remuneration disguised payment for past or future referrals?
  - To the joint venture
  - To a participant
- Remuneration can be, among other things
  - Dividends
  - Profit distributions
  - Contract payments

## OIG Scrutiny

- OIG factors in scrutinizing joint ventures:
- Manner in which joint venture participants are selected
  - Improper nexus between selection of venturers and volume or value of referrals
- Participants are expected to make substantial referrals
- Actions are taken to encourage referrals by participants

## Interplay of Financial Terms

- Tracking of referrals by participants
  - One participant (eg, hospital) already owns the business and other participant contributes little other than referrals
- Financing of investments and distribution of profits
  - Investment interests are offered at nominal value (significantly below fair market value)

## Investment, Profit Distributions

- Capital investment is disproportionately small, and profit distributions are disproportionately large, when compared to a typical investment in a new business enterprise
- Participants borrow capital contribution from other participants or joint venture, and repay loan from profit distributions

## Return on Investment

- Participants are paid an extraordinary return on investment, in comparison with the risk involved
- Substantial portion of the revenues of the joint venture derived from participants' referrals
- Note the interplay between initial capital investment and future profit distributions
  - Pivotal role of valuation
  - Must take into account OIG concerns

## Safe Harbors

- Consider available anti-kickback statute safe harbors:
  - Small entity investment
  - Investment in entity in underserved area
  - Hospital-physician ambulatory surgery center

## Income and Market Approach to Valuation

- Purchase of an interest in an ongoing business is frequently valued on income approach and market approach
  - Income approach – raises conundrum of projecting future revenues accurately without making indirect payments for referrals
    - Risks of using income approach versus difficulty in evaluating another approach that is a better measure of fair market value
    - Use assumptions that minimize risks of the income approach
    - Monitor documentation prepared by participants

## Market Approach

- Market approach – health care market often not subject to typical market forces
  - Example: Certificate of Need laws place premium on an existing license (franchise)
  - Impact of geographical location and payor mix varies greatly depending on the services provided

## Unwind Provisions; Problems

- Issue: How do venturers unwind a venture when a regulatory change prohibits future physician ownership?
  - Is ownership totally prohibited or only made less profitable?
  - Buy-out must be at fair market value
  - Is fair market value reduced as a result of the regulatory change?

## Provider/Non-provider Sites

- Infusion centers may have different payment levels depending on provider/non-provider status
  - Leases may provide physicians access to needed infusion services provided by providers
  - Lease safe harbor requirements include payments based on commercially reasonable, fair market value terms, unrelated to volume or value of services

## Intermediate Sanctions

- Rebuttable presumption of reasonableness under intermediate sanctions provisions of Internal Revenue Code, if the following occurs
  - Payments made by hospital to physician are at fair market value
  - Approved by Board committee in advance based upon appropriate data as to comparability
  - Documentation attached to determination

## Important Considerations

- Other important considerations
  - Selection of appraiser with particular expertise and experience with type of health care transactions at issue
  - Recognize third party rates and other contract terms, and potential future changes
  - Scrutinize comparables closely
  - Exempt entity should always take advantage of fair market value

## Contact Us

Daryl Johnson  
Principal  
HealthCare Appraisers, Inc.  
75 NW 1<sup>st</sup> Ave., Suite 201  
Delray Beach, FL 33444  
Tel: 561.330.3266  
[djohnson@hcfmv.com](mailto:djohnson@hcfmv.com)

Chris E. Rossman  
Partner  
Foley & Lardner LLP  
500 Woodward Ave., Suite 2700  
Detroit, MI 48226  
Tel: 313.234.7112  
[crossman@foley.com](mailto:crossman@foley.com)