AHLA

# 2016 Health Care Transactions Resource Guide

# Are You Paying Fair Market Value?

***Daniel Platten,*** *Director, Duff & Phelps*
*daniel.platten@duffandphelps.com*

***David Nadell,*** *Director, Duff & Phelps*
*david.nadell@duffandphelps.com*

***Rick Schwartz,*** *Managing Director, Duff & Phelps*
*rick.schwartz@duffandphelps.com*

## When Contemplating a Transaction, Fair Market Value Considerations are Critical

Health care providers receive scrutiny from regulatory agencies under anti-kickback, fraud and abuse, and pricing regulations. The federal government continues to aggressively pursue health care fraud and abuse with approximately $2 billion annually in judgments and settlements won or negotiated in recent years. Transactions may be reviewed and/or challenged by the Department of Health and Human Services Office of Inspector General, the U.S. Department of Justice, the Internal Revenue Service, and the Centers for Medicare and Medicaid Services, as well as state agencies. In addition to civil penalties, regulators have begun pursuing criminal charges against individuals.

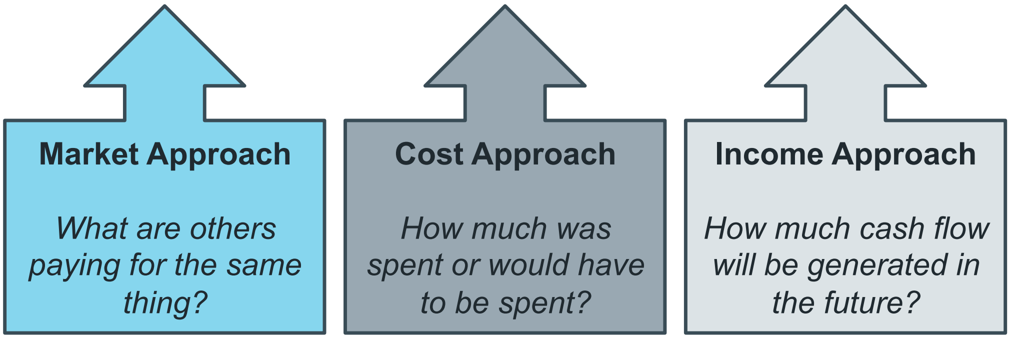
Federal and state statutes govern the pricing that is considered appropriate in deals involving transfers of businesses, or business assets such as property, as well as services. Included in these provisions is the requirement (with some exceptions) that health care entities may not pay more than fair market value (FMV) for the assets or services exchanged. Additionally, certain payments tied to patient volume or referrals are construed as inappropriate inducements and are not allowed. Tax-exempt entities face additional scrutiny to ensure that a contemplated transaction does not result in private inurement.

## What is Fair Market Value and How Can It Be Estimated?

Fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller if neither were under any compulsion to buy or sell and both parties had reasonable knowledge of the relevant facts.[1]

In addition, court decisions frequently state that the hypothetical buyer and seller are assumed to be able and willing to trade and be informed about the property and the market for

**Illustration 1. FMV Estimation Approaches**




1 26 CFR 53.4958-4(b)(1)(i); Rev. Rul. 59-60, 1959-1 C.B. 237.

such property. Further, the highest price a willing buyer would pay is also the price that a willing seller would accept[2] (Estate of Newhouse v. Commissioner, 94 TC 193 (1990)). Furthermore, in the context of health care regulatory compliance, FMV means the price that an asset would bring as the result of *bona fide* bargaining between well informed buyers and sellers who are not otherwise in a position to generate business for the other and that does not vary with, or take into account in any way, the referral or potential referral of patients or any other health care business between the parties for purposes of compliance with the Anti-Kickback Statute, the Stark Law, and Stark regulations. Prior to negotiating and closing a deal, a robust valuation supports the pricing of the transaction and helps ensure regulatory compliance during post-deal execution. So how might one value such a transaction? As shown in Illustration 1 (pg. 9), a Market Approach, Cost Approach, and/or Income Approach can support the FMV assessment of a business or service.

**Market Approach**

Ideally, one looks for the prices that others are paying for similar transactions in arm's length arrangements. In applying this "Market Approach," one seeks to find transactions that are as comparable as possible to the one we are reviewing. This is fairly straightforward when estimating the FMV of a relative commodity, such as bags of saline solution or four hours of medical chart coding. When valuing something less commoditized, however, we need to apply well-supported adjustments to the pricing of transactions that are as close to comparable as possible. But because business deals are typically complex multi-element transactions, comparable publicly-reported arm's length deals are often not found.

**Cost Approach**

Given the practical challenges in applying the Market Approach, the "Cost Approach," which values an asset based on what has been spent to create it or how much it would cost to re-create it, is sometimes considered. Here too, challenges exist. It may be difficult to identify relevant historical costs or to estimate the replacement cost. More importantly, the value of the asset may be substantially greater than the cost to create it due to strategic value that goes above and beyond the asset's cost.

**Income Approach**

A third approach, the "Income Approach," overcomes many of the challenges we have mentioned by valuing the business, asset, or service based on projected incremental cash flow. A discounted cash flow (DCF) estimates the present value of this cash flow by applying a discount rate that a market participant would consider appropriate given the riskiness and timing of the cash flow. When there is significant uncertainty surrounding the cash flow, for example, whether synergies projected for an acquisition will be fully achieved, multiple scenarios may be considered. Cash flows associated with each scenario are weighted by the corresponding likelihoods of the scenarios. The FMV pricing of the transaction would then be based on the resulting expected or probability-weighted DCF of the acquired business. If the transaction consideration involves multiple components (for example, an up-front payment and milestones tied to post-deal performance), then the analysis will consider the FMV of the transaction consideration as well as the FMV of the acquired business.

The Income Approach is not without its own set of challenges. The valuation is sensitive to the cash flow projections and other inputs, such as discount rate, tax rate, long-term growth rate, etc. As such, the assumptions behind these elements need

**Table 1. Spectrum of Transactions**

| Business Transactions | Property & Equipment Transactions | Distribution Services | Marketing, Advisory, & Educational Services | Data-Related Services |
|---|---|---|---|---|
| Practice or other health care entity acquisition | Lease transaction | Drug or device distribution services | Advisory boards, product reviews | Utilization data and analyses |
| Re-branding of an existing practice or entity | Real estate purchase or sale | Specialty pharmacy distribution services | Meetings, speaker events, CME programs | Sales or marketing data |
| Clinical or professional services arrangements | Medical equipment purchase or sale | Enhanced services such as product pedigree control | Market research studies, health provider surveys | Outcomes data and health economics studies |
| Co-marketing arrangement | Mobile equipment rentals | Reimbursement training to provider staff | Sales calls to physicians | Customized research studies |
| Other types of partnering arrangement | Facility-sharing arrangement | Managed care contracting support | Training and communications to patients, physicians, and pharmacies | Customized analyses and decision support tools |

2 26 CFR 53.4958-4(b)(1)(i); Rev. Rul. 59-60, 1959-1 C.B. 237.

**Table 2. Considerations in FMV Analysis**

| Potential Buyer/Seller Considerations |
|---|
| Income Taxes |
| Capital Expenditures |
| Depreciation and Amortization |
| Space and Rent |
| Staffing Levels |
| Corporate and Administrative Compensation |
| Physician Compensation |
| Personal Expenses |
| Favorable/Unfavorable Contracts |

to be well supported. Additionally, in structuring payments and developing the corresponding cash flow projections, we must be cognizant of the regulations governing payments tied to volumes or referral inducements.

## When Does Fair Market Value Matter?

Table 1 on page 10 provides examples across the spectrum of transactions in which FMV considerations are relevant. Although the complexity and materiality of a transaction may determine the depth of analysis and documentation that is appropriate, it is highly advised to address the FMV of any transaction in which relevant legal issues may apply.

## FMV Considerations in Business Transactions

Focusing on business deals in particular, we find that many health care entities believe they are paying FMV in a transaction based on historical financial information and observed data points in the marketplace. However, upon closer analysis of an entity, certain nuances of the business or specific facts and circumstances in a transaction reveal that FMV is not as clear-cut. Table 2 above includes a list of some common items to consider in a FMV analysis. The considerations in this article are strictly that—considerations; and specifically, as part of the Income Approach and Market Approach. Furthermore, the considerations in this article must be analyzed in the context of the facts and circumstances of a particular transaction.

**Income Taxes**

The U.S. health care system includes a significant proportion of not-for-profit (NFP) entities. The IRS and courts recognize health care entities that promote health for the benefit of the community as a charitable purpose. Assuming certain criteria are met, NFP health care entities are exempt from paying federal income taxes under I.R.C. 501(c)(3). However, a hypothetical buyer in a transaction can be either a for-profit entity or not-for-profit entity. Excluding income taxes in the FMV analysis of a health care entity can potentially violate certain private inurement restrictions.

Some have argued that for-profit entities will not enter certain markets due to the competitive landscape. However, many examples dispute this argument as there are typically no legal barriers (although there are certainly hurdles) that restrict a for-profit entity from entering markets historically served only by NFP entities. Recently, for example, LifePoint Health made acquisitions enabling it to enter new markets in Wisconsin and Pennsylvania that were historically served by NFP entities.

**Capital Expenditures**

When applying the DCF method within the Income Approach, it is critical to include the appropriate future capital expenditures as part of the projected future cash flow. Many health care entities are capital intensive in nature and require significant building improvements, new equipment purchases, and even new facilities to meet the standards driven by the market.

An imaging business with an aging or obsolete MRI machine is an example. FMV could potentially be overstated if the appropriate capital expenditures to invest in a new MRI machine are not included. At times, a health care entity may be able to refurbish an imaging machine to extend the economic life. However, the time will come when the machine needs to be replaced.

Alternatively, FMV could be understated if an imaging business has a new machine that is being underutilized or not operating efficiently. It is also important to analyze projected volumes and the capacity of machines. For example, if the local market demographics and competitive landscape support significant annual volume increases, will the imaging business require an additional machine(s) to satisfy demand? For an existing or new machine, what is the capacity to support higher volumes? For example, a 16 slice CT versus a 64 slice CT can impact the time and efficiency of a machine, which impacts the volume capacity of the business. Of course, the corresponding capital expenditure outlay will differ based on the type of machine purchased.

**Depreciation and Amortization**

Related to the capital expenditures, it is necessary to incorporate the tax depreciation of existing plant, property, and equipment (PP&E), as well as new PP&E from future capital expenditures. Book depreciation does not reflect actual cash flow of a business, which is why it is critical to project depreciation based on the appropriate tax methodology and lives.

Amortization is derived from acquired intangible assets, both existing and new, if any. In estimating FMV, it is critical to reflect the transaction structure, taxable or nontaxable. The transaction structure will drive certain assumptions related to depreciation and amortization.

**Space and Rent**

In establishing FMV, hypothetical buyer and seller assumptions must be utilized throughout the valuation analysis. Some businessess operate inefficiently and are deemed not to be representative in estimating the FMV. It would then be necessary to adjust certain income statement items. For example, a business may have obtained excess space with a long-term business plan of growing and utilizing the space. However, if the business plan has not been achieved and is not projected to come to fruition, an adjustment to the required space may be appropriate. Likewise, if the transaction involves a rental agreement that is at an above or below market rate, an adjustment to the rental amount may be appropriate. As mentioned earlier, it is necessary to reflect the facts and circumstances of a transaction or proposed transaction.

**Staffing Levels**

Similar to space and rent previously mentioned, staffing levels may not be appropriate based on current patient volumes. For example, a practice with declining volumes may continue to maintain a staffing level that is no longer necessary. In order to reflect a hypothetical buyer or seller, it may be appropriate to adjust staffing levels. Alternatively, if a physician practice or ancillary business is projecting a significant increase in volume, is the appropriate staffing level in place to support the increased volumes?

**Corporate and Administrative Compensation**

It is not uncommon to observe a private company pay above market compensation to certain employees, or even family members. Within a physician practice, the physician owner may have a long-term business relationship with a practice administrator which has resulted in above market compensation. Other times, we have observed family members receiving a salary that does not match the contributions to the business. Although acceptable for a privately-held company to operate at its own discretion, these expenses are not representative of FMV and may be adjusted accordingly.

**Physician Compensation**

It is critical to incorporate post-transaction compensation in a DCF analysis. Not doing so may overstate FMV. Often we see transactions where the post-transaction compensation is yet to be determined. In these situations, it may be appropriate to include the proposed post-transaction terms; however, if there are any changes to the proposed terms, it is important to update the valuation before closing. In many physician practice transactions, there are highly productive physicians who will leave the practice post-transaction. In these situations, it is important to consider whether a single replacement for that physician will be sufficient to support the projected post-transaction volumes.

**Personal Expenses**

Private companies often include personal expenses, such as automobile, insurance, and travel, and categorize those expenses as business expenses. If these are not required business expenses from a FMV perspective, it may be appropriate to adjust accordingly.

**Favorable/Unfavorable Contracts**

Depending on the size, competency, and negotiating power of a target company, other contracts or agreements such as leases may be favorable or unfavorable relative to market rates or benchmarks. In an FMV analysis, it may be appropriate to normalize these contracts or agreements to reflect a hypothetical buyer or seller. For example, if an assisted living business has a relationship with a lab supply company and executes a supply contract that is not at arm's length, it is generally appropriate to adjust accordingly.

## FMV Considerations in Services Transactions

Table 1 (pg. 10) provides examples across a spectrum of distribution, marketing, advisory, educational, and data-related areas. When services arrangements are already in place prior to executing a business transaction, existing contracts should be reviewed carefully to ensure compliance with applicable regulations, including an analysis of whether pricing terms are at FMV. This should typically be done as part of, or in concert with, the due diligence process. If yellow flags are raised in reviewing the existing contracts, they should be addressed either by seeking suspension, modification, or carve-out of questionable contracts, or by incorporating contingent consideration or indemnifications into the current transaction to help control risks.

In reviewing contracts in place, a process similar to ordinary course-of-business FMV analysis is advisable, albeit on a more expedited path given the typical timeframes for consummating a deal. The valuation approaches described earlier (see Illustration 1, pg. 9)—Market Approach, Cost Approach, and Income Approach—may apply, and so do their challenges. As with all valuations, when multiple approaches can be used, there will be stronger support for the concluded value.

## Payments to Health Care Providers

We focus now on two areas of particular concern: payments to health care providers and payments for data.

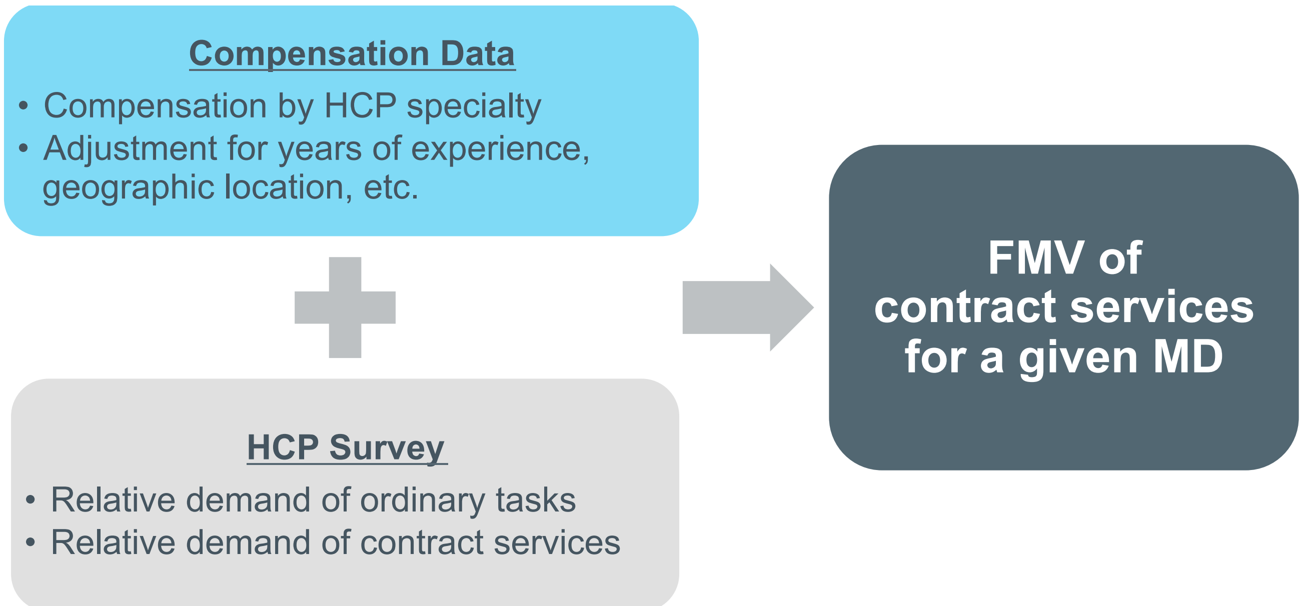
Manufacturers enter into contracts with Health Care Providers (HCPs) for a wide variety of marketing, educational, and advisory services, and HCPs may expect and be entitled to receive levels of compensation that reflect the varying degree of effort and expertise that is demanded by a given activity. These arrangements can create an actual or perceived conflict of interest. Payments to HCPs for these services could be viewed as a kickback in exchange for using a manufacturer's products if the payments are not at FMV.

From 2013 to 2015, dozens of companies have been investigated with publically disclosed penalties and settlements for allegations of inappropriate pricing and off-label promotion averaging over $750 million per year. Additionally, payments to HCPs for clinical services can receive scrutiny; notable cases include U.S. v. Tuomey and U.S. v. Halifax, which resulted in a verdict of over $200 million and a settlement of $85 million, respectively.

The following scenario demonstrates how a valuation that properly reflects the difficulty of a given task and the characteristics of the physician can support compensation greater than $500 per hour for certain activities and individuals.

A manufacturer and distributer of medical devices to orthopedic surgeons, spine surgeons, and neurosurgeons planned to contract with selected surgeons for various services, including assistance with product development, product evaluation, training product marketing representatives, serving on advisory boards, and serving as medical advisor.s They needed to ensure that payments for these services were at FMV. Typically, most approaches begin by identifying a baseline compensation range for the each

Illustration 2. Demand-Adjusted Compensation




physician specialty using third-party compensation data. This data can go beyond differentiating only by physician specialty to provide support for levels of compensation that vary with the HCP's location, years of experience, and other characteristics.

Compensation data alone provides limited support for remuneration that reflects the nature of the services being contracted for. Specifically, some services place greater demands on the HCP. For example, payment for an hour of an HCP's time to serve on an advisory board should likely be greater than an hour of the same HCP's time to complete a product survey. Depending on the task, the required effort, knowledge, skills, risks, and responsibility can justify a relatively higher or lower remuneration than reliance only on compensation benchmarks would suggest.

As an example, to implement this "demand-adjusted compensation" approach (see Illustration 2 above), we measured how HCPs view the burdens of a given activity through a brief telephone survey with orthopedic, neurological, and spine surgeons. After defining the "demand" of an activity as described above, HCPs were asked to rate the demand of specific activities, including both ordinary activities as a surgeon and those such as providing training, advisory board service, and product evaluation that they might be contracted to provide on behalf of a manufacturer. Activities that are rated as more demanding justify a relatively higher level compensation.

Integrating compensation data and HCP ratings of the demands of each activity provides a well-supported FMV conclusion. The FMV of each service is the compensation range appropriate for a provider in a given region with similar specialty and years of experience, adjusted to reflect the demand of the activity.

This demand-adjusted compensation approach works well when the services to be valued are well-defined, easy to communicate to HCPs, and have limited variability (i.e., where an hour of the service is essentially the same regardless of which manufacturer contracts for it or which HCP provides it). An alternative approach, conjoint measurement, infers preferences for product and service attributes through trade-off questions that pose choices between hypothetical products and services. In the context of payments to HCPs, we have used conjoint measurement to provide highly refined, robust valuations of services that vary on numerous characteristics or in subtle ways from one another, such as in the number of hours required, the amount of preparation needed in advance of delivering a program or service, or the distance from the HCP's location to where the service will be provided.

We have described how to go beyond relying exclusively upon compensation data by adjusting for the demand of an activity using HCP perceptions expressed directly or inferred from choices made in a conjoint approach. Which approach to use depends largely on the materiality of the program addressed and the breadth and variation of the services being valued.

Ensuring that payments to HCPs are at FMV is only one piece of ensuring compliance with anti-kickback statutes, as indicated by the compliance review checklist (see Table 3, pg. 14). Regulators may also scrutinize the commercial reasonableness of an arrangement with HCPs, whether an arrangement provides rewards for the volume or value of referrals or business generated, and whether the aggregate amount paid to any one HCP in a given year is excessive.

## Payments for Data

Payments for health care data are growing in importance due to the increased use of data by manufacturers and health care systems to drive design, development, pricing, marketing of products and services, and the increasing focus by public payers and

**Table 3. Compliance Checklist**

| Compliance Review Checklist: Payments to HCPs |
|---|
| ☐ Is the HCP's background appropriate for the activity and payment amount? |
| ☐ Are regional differences captured? |
| ☐ Is the intensity and specific requirements of the activity reflected in the payment? |
| ☐ Does the arrangement provide implicit or explicit incentives or rewards for referral volume or value? |
| ☐ Are the aggregate payments to an individual HCP or individual entity reasonable? |
| ☐ Are data sources used to estimate the FMV credible? |
| ☐ Is the methodology for estimating the FMV consistent and transparent? |
| ☐ Is the rationale for payments at the higher or lower end of a FMV range supportable and documented? |

insurers on outcomes-driven health care. Hospitals, physician practices, pharmacies, and other entities collect vast amounts of data on treatment patterns, patient outcomes, and product usage in their ordinary course of business. This data is a valuable source of market intelligence for manufacturers and providers; however, payments received for the data are subject to scrutiny under anti-kickback, pricing, and other statutes.

Determining the FMV of data is often challenging due to the uniqueness of a given data set and the variety of data-driven products and services that may be associated with a data set. We will describe an approach we have used to value a variety of data products from one such provider.

Contracts for data services often include an initiation cost or setup fee for the work of tailoring a data set or product offering to a customer's needs, along with an annual subscription-type fee for the data or product itself. The FMV of the setup fee can be estimated using a Cost Approach, as the uniqueness of a given data set implies that unique activities and/or levels of resources may be needed to create it. Finding market data to support direct estimation of the setup fee is likely not possible. The fee for the data itself is addressed via a Market Approach, as we will describe later.

In applying the Cost Approach to estimate the FMV of the setup fee, if the organization has captured historical information, we consider the average and range of resources it has incurred per customer to on-board similar customers. This can inform projections of the resources that would be needed to on-board a given customer. The resource estimates are typically a range of hours by job title and reflect the variability across customers to on-board them for a given service, e.g., based on the complexity of the required data set, whether multiple data sources need to be integrated, the number of organizational touchpoints involved, and other factors. Care needs to be taken to allocate the resources on a per-data set or per-product basis for activities that support multiple products or customers.

The total cost for setup is based on the required resources and the fully loaded salary of each resource, as supported by industry compensation benchmarks. Finally, a Fair Margin is applied to the total cost based on the observed margins of comparable public companies.

Turning to the FMV analysis of the data itself, a Market Approach is typically used. If similar data products are available from several providers, the FMV of the data can be supported by the prices others charge for comparable products. Often though, the prices charged by other data providers are not publicly reported or their products are not similar enough to be considered comparable.

As an alternative, information from a survey of "data buyers" can support application of the Market Approach by measuring buyers' likelihood to purchase depending on price and other characteristics. The survey can present hypothetical data sets and product offerings that vary in the types of data, geographic/patient/specialty coverage of the data sets, frequency of updates, and other characteristics that differentiate products and providers.

From their responses, the willingness-to-pay of each buyer for various products is estimated. Willingness-to-pay is a measure of the likelihood that a buyer will purchase a data product at a given price and reflects both how well the product meets the buyer's needs and other alternatives the buyer may have, either through another data product or provider, or by addressing the need internally or through other means. The final step is to estimate the FMV for each product based on a willingness-to-pay estimate for the market that is aggregated across survey respondents.

The combination of the Cost Approach for the setup fee and a survey-based Market Approach for the data product or subscription provides the support needed to justify the FMV pricing for unique data products. Additionally, the conjoint measurement approach mentioned in the preceding section can be used to provide robust support for FMV pricing of data products that vary along a broader and deeper spectrum.

## So, Are You Paying Fair Market Value?

In this discussion we have highlighted FMV considerations when pursuing or reviewing business and service transactions. FMV principles apply across the broad spectrum of health care transactions, but since no two transactions are alike, facts and circumstances must be considered. Whenever possible, more than one valuation approach should be used. An experienced and independent third party can facilitate the evaluation process and help lend confidence to your FMV conclusions. ◆