Conceptualizing Fair Market Value in Compensation Arrangements

I. Defining Fair Market Value

a. Definition of FMV

i. 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 seller is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.”¹

ii. 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.”²

b. FMV and other standards of value

i. Key differences in standards of value

1. Fair market value

Fair market value is the value a typical buyer would pay to a typical seller, in arms-length negotiations, with neither under influence.

2. Fair value

Fair value is a statutory or judicial term, which generally varies from state to state, usually associated with dissenting shareholder action or corporate dissolution. One of the key differences between fair market value and fair value is the absence of a “willing seller” in the context of fair value. Furthermore, the seller may not be knowledgeable, and is often under compulsion to sell.

¹ Revenue Ruling 59-60.
² International Glossary of Business Valuation Terms, American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, and The Institute of Business Appraisers.
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3. Investment value

Investment value relates to the strategic value or the value to a specific buyer, rather than the universe of hypothetical buyers.

4. Other standards of value

Intrinsic value – the amount an investor considers the worth of a company, based on a fundamental analysis of the company’s assets or earnings.

Liquidation value – the value in a forced sale. The seller may be unwilling, under compulsion and specific, and may not be knowledgeable.

Use value – specified use, other than highest and best use.

ii. Tabular comparison of key concepts

<table>
<thead>
<tr>
<th>Fair Market Value</th>
<th>Fair Value</th>
<th>Investment Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Willing buyer</td>
<td>Willing or unwilling buyer</td>
<td>Willing buyer</td>
</tr>
<tr>
<td>Willing seller</td>
<td>Unwilling seller</td>
<td>Willing seller</td>
</tr>
<tr>
<td>Neither under compulsion</td>
<td>Seller is under compulsion</td>
<td>Neither under compulsion</td>
</tr>
<tr>
<td>Hypothetical buyer and seller</td>
<td>Specific buyer and seller</td>
<td>Specific buyer</td>
</tr>
<tr>
<td>Buyer and seller are both knowledgeable</td>
<td>Seller may not be knowledgeable</td>
<td>Buyer and seller are both knowledgeable</td>
</tr>
</tbody>
</table>
II. Fair Market Value from a Health Care Regulatory Perspective

a. Physician Self-Referral Law (Stark law)

i. General prohibition

A physician cannot make a referral to an entity for the furnishing of designated health services payable by Medicare or Medicaid if the physician has a financial relationship with the entity, unless an exception applies.\(^3\)

ii. Pervasiveness of FMV in exceptions

1. §411.355(e) – Academic medical centers
2. §411.357(a) – Rental of office space
3. §411.357(b) – Rental of equipment
4. §411.357(c) – Bona fide employment relationships
5. §411.357(d) – Personal service arrangements
6. §411.357(f) – Isolated transactions
7. §411.357(h) – Group practice arrangements with hospitals
8. §411.357(i) – Payments by a physician
9. §411.357(l) – Fair market value compensation
10. §411.357(p) – Indirect compensation arrangements

iii. The Stark definition of FMV

“Fair market value means the value in arm's-length transactions, consistent with the general market value. ‘General market value’ 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 party, or the compensation that would be included in a service agreement as the result of bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement.”

\(^3\) 42 C.F.R. §1395 mn.
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“Usually, the fair market price is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition, or the compensation that has been included in bona fide service agreements with comparable terms at the time of the agreement, where the price or compensation has not been determined in any manner that takes into account the volume or value of anticipated or actual referrals.

“With respect to rentals and leases described in Sec. 411.357(a), (b), and (l) (as to equipment leases only), ‘fair market value’ means the value of rental property for general commercial purposes (not taking into account its intended use). In the case of a lease of space, this value may not be adjusted to reflect the additional value the prospective lessee or lessor would attribute to the proximity or convenience to the lessor when the lessor is a potential source of patient referrals to the lessee. For purposes of this definition, a rental payment does not take into account intended use if it takes into account costs incurred by the lessor in developing or upgrading the property or maintaining the property or its improvements.”

iv. FMV safe harbor hourly physician compensation rates under §411.351

1. ERP method

   The hourly rate is less than or equal to the average hourly rate for emergency room physician services in the relevant physician market, provided there are at least three hospitals providing emergency room services in the market.

2. National survey method

   The hourly rate is determined by averaging the 50th percentile national compensation level for physicians with the same physician specialty from at least four of the five survey reports identified by CMS, and dividing by 2,000 hours.

b. FMV Safe Harbor Pitfalls - Experience with the new fair market value safe harbor has highlighted some weaknesses that must be considered when evaluating the effectiveness of the methodology. Below are listed several shortcomings applicable to the two methods identified by CMS in the new safe harbor.

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5 Ibid.
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i. Shortcomings of the ER Physician Market Methodology

1. CMS does not define the “relevant market” identified in the preamble or regulations;

2. Finding three hospitals in the relevant market with emergency services that are willing to share this information is difficult;

3. The compensation of ERPs ignores wide ranges of compensation among specialties; and

4. ERP compensation disregards the nuances of shortage specialties.

ii. Shortcomings of the National Survey Method

1. National survey data is not region-specific; some regions have significant variances compared to national data and many markets have their own unique features;

2. Some surveys have limited subspecialty data, such as cardiology (invasive, interventional and non-invasive);

3. Some surveys may be tainted by small number of responses;

4. Other widely recognized surveys are omitted (e.g., American Medical Group Association); and

5. Cost.

iii. Shortcomings Applicable to Both Methods

1. Both methods apply only to hourly payments to physicians;

2. Neither method addresses aggregate compensation;

3. Both are ineffective when community need or physician shortage affects physician recruitment, or in the case of highly qualified or highly productive physicians; and

4. Average methodology may distort the results, particularly if surveys vary widely.
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iv. January 14 suit filed by Renal Physicians Association against DHHS and CMS

1. RPA Alleged that the Fair Market Value Safe Harbor will:

   a. Adversely affect the quality of dialysis patient care

   b. Make it difficult for dialysis facilities to recruit individuals with training and experience needed to be effective medical directors

   c. Other RPA Allegations:

      i. HHS failed to follow Administrative Procedures Act

      ii. Surveys are non-existent, outdated or difficult to obtain

   d. RPA Concerns:

      i. Facilities will require the FMVSH, which will become the norm

      ii. Result in unfair compensation

      iii. Cause declines in medical director compensation

   c. Federal anti-kickback statute FMV definitions for space and equipment rental and personal services and management contracts

      i. Space rental

      Fair market value is the value of rental property for general commercial purposes, not adjusted to reflect the additional value that a party would attribute to the property because of proximity or convenience.\(^6\)

\(^6\) 42 C.F.R. §1001.952(b).
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ii. Equipment rental

Fair market value is the value of equipment when obtained from a manufacturer or professional distributor, but not adjusted to reflect the additional value that a party would attribute to the property because of proximity or convenience.  

d. Differences between traditional and regulatory definitions of FMV

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

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7 42 C.F.R. §1001.952(c).
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III. Key Appraisal Concepts

a. The three broad approaches to valuation and application in the context of general appraisal practice

   i. Cost based approach

   Cost-based methods indicate value through a process of summation of an entity’s individual assets and liabilities, adjusted to fair market value, often including consideration of the cost to recreate or reconstruct the asset or business interest.

   ii. Income based approach

   Application of income-based methods generally involves establishing an income figure for the company being valued, determining the appropriate relationship between income and value, and then converting the estimated income into an estimate of value.

   iii. Market based approach

   Market-based methods indicate the value of an asset or equity interest by comparing the subject interest to similar investments that have been sold. It is the most direct approach for the determination of value. The market-based approach is based on the principle of substitution (see below). In using this approach, the appraiser looks at the market to see what similar assets or business interests are worth.

b. Three central principles of appraisal

   i. Principle of alternatives: each party to a transaction has alternatives to completing the transaction, including other investments.

   ii. Principle of substitution: a buyer will not pay more for something than for a equally desirable substitute.

   iii. Principle of future benefits: the value of an investment is derived from the associated future economic benefits.
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IV. Correlation of General Appraisal Practice to Service Agreement Valuation

a. Examples of service arrangements involving physicians:
   i. Employment agreements
   ii. Independent contractor arrangements
   iii. Medical or program directorship contracts
   iv. Shared use or cost arrangements
   v. Lease arrangements
   vi. Management service agreements

b. Comparison of key FMV concepts

<table>
<thead>
<tr>
<th>Assets or Business Interests</th>
<th>Service Agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Willingness of buyer and seller</td>
<td>Willingness of purchaser and provider of the goods or services</td>
</tr>
<tr>
<td>Hypothetical universe of buyer and seller</td>
<td>Hypothetical universe of purchasers and providers of the goods or services</td>
</tr>
<tr>
<td>Neither under compulsion</td>
<td>Neither under compulsion</td>
</tr>
<tr>
<td>Buyer and seller are both knowledgeable</td>
<td>Purchaser and provider of the goods or services are both knowledgeable</td>
</tr>
<tr>
<td>Result of <em>bona fide</em> bargaining</td>
<td>Result of <em>bona fide</em> bargaining</td>
</tr>
<tr>
<td>Neither buyer nor seller are in a position to generate business for the other party</td>
<td>Neither purchaser nor provider of the goods or services are in a position to generate business for the other party</td>
</tr>
</tbody>
</table>
c. Application of the three broad approaches to service agreements

i. Cost based approach

1. Use of income projections under the cost approach

   a. Avoided costs under the principle of substitution – the consideration of the cost of an equally desirable (undesirable) substitute

   b. Use of projections of physician losses (professional fee revenues less physician compensation and overhead) under an employment arrangement as an alternative to recruitment or call coverage

   c. Build-up cost methodology for shared use, and per-click agreements

      i. Cost, plus

         ii. Reasonable rate of return

2. Buyer’s vs. seller’s perspective

   a. Make-or-buy decision

   b. Reasonable markup is grounded in the shifting of some or all risk from seller to buyer

ii. Income based approach

1. Applying the principle of future benefits – establishing an income stream and converting that stream to value

2. Reimbursement, less costs, plus a reasonable rate of return

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3. Buyer’s vs. seller’s perspective
   a. Buyer’s perspective may not be relevant (i.e., seller bills for professional services under call arrangement)
   b. Seller’s perspective may be an alternative

iii. Market based approach
   1. Comparable transactions must be comparable
      a. Billing and collection of professional and technical component fees and appropriate matching of costs
      b. Simple lease v. turnkey deal
      c. Excludes tainted transactions between parties with referral relationships

iv. Synthesis, reconciliation and conclusion
   1. Combination or weighting of relevance
   2. Development of floors or ceilings
   3. Reasonableness tests for other methods

v. Understanding the Issues and Risks
   1. Know the legal constrains.

   Valuation analysts, appraisers, consultants or other experts employed or retained by the organization should possess a level of knowledge of the legal restrictions associated with the proposed arrangement and how the legal environment affects the definition and determination of fair market value.
2. Understand the makeup of the parties to the contract.

The relationship of parties to the agreement is of great significance, particularly when a referral relationship exists. For example, synergies between a physician and a hospital to which the physician refers patients, if considered in the value conclusion, could lead to an illegal arrangement.

3. Understand the billing and reimbursement ramifications.

Many arrangements, such as those involving physicians and hospital systems, may be significantly impacted by the nature of the billing arrangements. Billing and reimbursement issues often drive the structure of the arrangement.

4. Work with market data and financial and statistical reports.

Volumes of data are available on the medical practice of physicians, but failure to understand and properly apply this data could result in errors in the conclusion of value. Furthermore, misunderstanding historical financial and statistical data can also lead to incorrect assumptions. The following represent some potential errors that can occur in a misunderstanding of physician productivity:

a. Incorrectly including technical component production in an analysis of physician production or misinterpreting global billings for professional component production.

b. Misuse of market data, such as incorrect specialty data (e.g., cardiology sub-specialization).

c. Failure to consider payer mix, patient acuity and other market forces affecting the productivity of physicians.

d. Improperly measuring incident-to productivity.

e. Misunderstanding data provided by physician practice management system reports.
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f. Misusing survey or other market data on physician compensation when other compensatory arrangements exist outside the subject agreement, such as expert witness fees, administrative arrangements or consulting income.

5. Recognize multiple components of an arrangement.

Many arrangements between health systems and physicians contain multiple components, including medical directorship duties, shared cost arrangements, and equipment leasing.

6. Consider the significance of community need or physician shortages.

Market dynamics have a distinct impact on how physician arrangements are structured, including the remuneration paid in consideration for the physician’s service.