

Establishing Fair Market Value under the Anti-kickback and Stark Laws

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Overview

- Legal Issues
 - Regulatory Guidance on FMV
- Valuation Issues
 - Emerging Topics in Valuation

Legal Issues

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The Anti-kickback Statute

- Remuneration paid with the intent to induce referrals violates the Statute
- Presumption that payment in excess of FMV or below FMV is payment for referrals
- FMV is component of certain AKS safe harbors
 - Personal Services/Management Agreements
 - Space and Equipment Leases

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AKS Regulatory Guidance -- OIG Position

- 1994 Special Fraud Alert
 - “FMV must reflect an arm’s-length transaction which has not been adjusted to include the additional value which one or both of the parties has attributed to the referral between them.”
- OIG Compliance Guidance for Individual and Small Group Practices (2000)
 - “The OIG’s definition of FMV excludes any value attributable to the referrals of Federal program business or the ability to influence the flow of business. Adhering to the rule of keeping business arrangements at FMV is not a guarantee of legality, but is a highly useful general rule.”

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AKS Regulatory Guidance – OIG Position

- *Hanlester* – OIG argued that excess value available to be earned by investors over referrals to an outside lab compensated them for control over referral stream
- Advisory Opinions – carefully avoid the subject

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AKS Regulatory Guidance -- Leases

- Per Safe Harbor
 - No Single Figure
 - Range of rental fees within reasonable commercial range
 - Not taking into account value attached by either party based on proximity or convenience to referral source
 - May consider cost of leasehold improvements
 - Preamble -- "Hospitals that give rent concessions to staff physicians leasing private office space may not fall within the safe harbor."

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OIG Special Fraud Alert -- Leases

- Rental of Space in Physician Offices (2000)
- Factors:
 - Whether any rent appropriate
 - Payment at FMV
 - Payment for premises of size and time reasonably necessary for commercially reasonable business purpose of supplier
 - Not in excess of rate paid by physicians in primary lease space
 - Prorated based on exclusive office space, interior office common space, building common space

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Stark

- Entity cannot accept referrals from, or bill Medicare for designated health services referred by, physicians with whom the entity has a financial relationship unless the relationship falls within an exception
- Most compensation exceptions require FMV
 - Space and Equipment Leases
 - PSA's
 - Employment
 - Payments by Physicians
 - FMV Exception

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Stark – General FMV Guidance

- General Rule: Remuneration must be FMV and not determined, directly or indirectly, in a way that takes into account the volume or value of referrals (or other business) to the entity

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Stark II – Statutory Guidance

- Stark Statute – 42 U.S.C. 1877nn(h)(3)
 - Value in arms-length transactions, consistent with general market value
 - Rentals or Leases – value of rental property for general commercial purposes, not taking into account its intended use
 - Space Lease – not taking into account the value the lessee or lessor would attribute to proximity or convenience

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Stark II Regulations -- 42 C.F.R. 411.351

- “General market value”
 - Price that an asset would bring, 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 the acquisition of the asset or at the time of the service agreement.
 - Price of bona fide sales for assets of like type, quality and quantity in particular market
 - Compensation included in bona fide service agreement with comparable terms at the time
 - Not determined in any manner that takes into account the volume or value of anticipated or actual referrals

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Stark – Preamble to Phase I Regs

- Not possible to list benchmarks or objective measures
- Will accept any method that is commercially reasonable and provides evidence that compensation is comparable for item or service in the market in arm's-length transactions by parties not in a position to refer
- In some circumstances, "volume or value" restriction will preclude reliance on comparables that involve parties in a position to refer

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Preamble to Phase I Regs – Identified Methodologies

- No single methodology will apply
 - Good faith, written assurance from the party paying or receiving compensation
 - List of comparable office space
 - Appraisal from independent expert
 - Cost plus reasonable rate of return
 - Consulting a price list
 - IRS guidelines in certain, unspecified circumstances if appropriate

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Preamble to Phase I Regs – Proving FMV

- Amount of documentation will vary
- Burden of establishing fairness on the parties
- Good faith reliance relevant to intent, but does not establish accuracy of valuation

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Preamble to Phase I Regs – Independent Valuations

- No requirement to use independent valuation consultants when other appropriate valuation methods available
- “However, while internally generated surveys can be appropriate as a method of establishing fair market value in some circumstances, due to their susceptibility to manipulation and absent independent verification, such surveys do not have strong evidentiary value and, therefore, may be subject to more intensive scrutiny than an independent survey.”

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Stark II Phase II Regs – Physician Compensation

- Physician Compensation for Professional and Administrative Services
- New “Stark Safe Harbor” for hourly payments. Either:
 - Less than or equal to average hourly rate for ER physician services in the relevant market, provided at least three hospitals providing ER services in the market
 - Average of 50th percentile national compensation level for same specialty (or if not identified, for general practice) of at least 4 of 6 specified surveys, divided by 2,000 hours
- Safe harbor voluntary, other valuation methodologies also acceptable

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Stark II Phase I Regs -- Leases

- General commercial space
- Not adjusted for proximity or convenience to the lessor when lessor is a potential referral source
- May take into account costs of developing, upgrading or improving property
- Separate requirement that be “commercially reasonable” even if no referrals made between parties

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Stark FMV Cases

- *Goodstein v. McLaren*, 202 F. Supp. 2d 671 (E.D. Mich 2002)
 - Government t alleged rent paid by hospital to physician owners of building exceeded FMV
 - Numerous experts on both sides
 - Court concluded rent did not exceed FMV
 - Found arms length transaction
 - **Intense, protracted price negotiations**
 - **Hospital got most of what it asked for, terms advantageous to hospital**
 - No evidence value or volume of referrals taken into account in establishing rental rate

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Stark FMV Cases -- *McLaren*

- Court rejected government's experts because they excluded relevant comparable buildings
 - Considered only gross leases; defense experts considered both gross and triple net leases
 - Used more restrictive market area than defense experts
 - Failed to adjust for unique way square footage accounted for under McLaren lease
 - One government expert had no comparables

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Appropriate Valuation Approaches

- Goal: Establish understanding of the relationship between quantitative assumptions and regulatory factors
- Problem: Professional standards in the valuation community oft times appear to conflict with regulatory requirements for healthcare valuation
- Differing Definitions of Fair Market Value
 - Revenue Ruling 5-60
 - International Glossary of Business Valuation Terms
 - Stark II, Phases 1 and 2

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What is included in Fair Market Value?

- **All** of the cash flows associated with the operating assets of the entity
 - Tangible assets like equipment
 - Working capital – accounts receivable
 - Enterprise goodwill
 - Personal goodwill
- Double counting results in a payment that exceeds fair market value
 - Common problem with physician practice valuation and post-purchase physician compensation

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Noncompetes and Referrals

- The valuation technique commonly accepted for valuing a noncompete considers the business lost by the holder of the noncompete if it were violated.
 - Query if this implicates the AKS?
 - The value of a noncompete is part of the enterprise level operating cashflows of a business!
 - For compensation arrangements, local law needs to be evaluated to see if continued employment is adequate compensation for the noncompete

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Valuation Models: Income Approach

- **All** valuation is about *future cashflow*, not historical cashflow, and a *valuation multiple* that is based upon the *risk* of that future cashflow
- Simple valuation formula: Cashflow **times** Valuation Multiple **equals** Value
- Risk is based upon empirical evidence and judgment
 - Underestimating risk overstates value
 - Overestimating risk understates value
- Valuers without detailed healthcare industry knowledge typically underestimate risk

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Valuation Models : Income Approach

- Types of Risk
 - Regulatory Risk
 - Investment Risk
 - Size Risk – small entities are much more risky than large entities
 - Specific market risk such as dominance by a few health insurers – this is very poorly understood
 - Reimbursement Risk – e.g., home health care, MRI, outpatient therapies, outlier payments
- Detailed Industry Knowledge required for risk assessment

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Valuation Models : Income Approach

- Growth Rates
 - The greatest risk of overestimating value and implicating Stark or AKS is improper or unrealistic assumptions as to future growth in cashflow or profits
 - For Part B services, look at history of Medicare Conversion Factor and Producer Price Index
 - For Part A, there is usually a market basket update (similar to inflation)
 - Profit margins often erode as costs rise faster than per unit revenues leading to increased utilization to maintain profits – which then leads to regulatory or legislative action

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Valuation Models : Market Approach

- Market Approach is premised on finding comparable data and applying it to what you are trying to value
- Generic Valuation
 - Comparable transactions
- Business Valuation
 - Guideline Publicly Traded Company Method
 - Merged and Acquired Company Method or Direct Market Method
- Very few experienced healthcare appraisers use the Guideline method UNLESS the public company operates in the same state and in the precise line of business as what you are trying to value

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Valuation Models : Market Approach

- Direct Market Method
 - Stark regs create special rules – what is relevance of a transaction in Ohio to a proposed transaction in Texas?
 - Common source of valuation errors
 - See *Caracci* Appellate decision
- Comparable transactions
 - “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...”

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Valuation Models : Market Approach

- Comparable transactions
 - No way of knowing if parties considered proscribed referrals in determining the transaction price!
 - Value paid by Consolidator (e.g., Physician Practice Management Companies) is ONLY relevant during the consolidation and ONLY if the entity being valued is a likely target.

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Summary

- Income approach typically used due to regulatory environment
- Market methods pose significant risk as details of a particular transaction in a database or public record are rarely known
- An asset that has or will generate **no** cash flow within the parameters of the law and regulations has **no** value to the hypothetical buyer of the fair market value standard

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