Fair Market Value Bootcamp Webinar and Roundtable Discussion Series: Part IV

This webinar and roundtable discussion series is brought to you by the Fair Market Value (FMV) Affinity Group of the Hospitals and Health Systems (HHS) Practice Group, and co-sponsored by the In-House Counsel (In-House), Life Sciences (LS), and Physician Organizations (Physicians) Practice Groups.

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Introduction to the Boot Camp

- **Objectives**
  - Use a hypothetical case study with common transaction elements to illustrate fair market value issues that health care attorneys may encounter when representing hospitals, health systems or referring physicians

- **Bootcamp Timeline**
  - Simulcast: June 26, 2012 – Part I
  - Webinar: September 12, 2012 – Part II
  - Roundtable: November 7, 2012 – Part III
  - Roundtable: January 23, 2013 – Part IV
  - Webinar: April 24, 2013 – Part V
Hypothetical Case Study for FMV Boot Camp:

- Physician practice being acquired by tax-exempt hospital
- Physician practice specialty is or includes cardiology
- Physician practice includes significant ancillary services made up of designated health services (DHS) as defined under the Stark Law
- Physician practice is historically the sole provider of certain DHS in the community
Hypothetical Case Study for FMV Boot Camp:

- Hospital does not perform certain of the DHS performed by the physician practice.
- Upon sale to the hospital, practice physicians will be employed by the hospital in a Stark-defined group practice.
- Upon sale to the hospital, some of the DHS will be converted to HOPD services; some will remain in the post-sale group practice.
- The physician practice includes physicians of multiple specialties; physicians of one of the specialties are threatening to pull out of the practice.
Hypothetical Case Study for FMV Boot Camp:

- Hospital CEO is particularly aggressive and has agreed in the past to physician demands to pay one of the specialties a rate for ED on-call pay that is in excess of FMV as established by an FMV opinion from an outside valuation firm.
- Hospital board has asked that counsel provide the board with an independent opinion that the acquisition and related employment are commercially reasonable.
- Hospital board also asked to secure a valuation firm to opine on FMV of the practice and the compensation arrangements.
Summary of Bootcamp Parts I, II & III:

- Topics Discussed:
  - Attorney-client privilege
  - Commercial reasonableness
  - What to consider before contacting the valuation expert
  - Selection of a valuation expert
  - The valuation engagement letter
  - Valuator data needs and access
  - Approaches to valuation/fundamentals of valuation theory
  - Key Elements of a Valuation Report
  - Brief discussion of the role of counsel in the valuation process
  - Brief discussion of the issues that arise when valuation opinions are inconsistent and/or valuators disagree
Overview of Bootcamp Part IV:

- Hypothetical Context ("Where we are")
  - Hospital has engaged separate valuation firms to perform practice valuation and post-transaction compensation valuation.
  - Both valuation firms have issued draft FMV reports.
  - Draft valuation reports contain certain conflicting assumptions, and both contain opinions of FMV that are inconsistent with the expectations of the hospital and practice, and the amounts that they have been discussing in negotiations.
  - Hospital and physician counsel are under pressure to "make the deal happen" and are consulting with each valuation firm to try to determine appropriate next steps.
Overview of Bootcamp Part IV:

Focus Areas

- Reasons for and resolutions to disagreement of valuation firms about appropriate market data and valuation methodologies for physician compensation arrangements following the hospital’s acquisition of the subject practice

- How and when parties may seek to address lost physician income from ancillaries in a physician practice acquisition, being mindful of legal concerns related to compensation “double-dipping”
Overview of Bootcamp Part IV:

- Topics to be Covered:
  - Advanced discussion of business and compensation valuation methods, with emphasis on the theoretical, practical and case-specific factors that may lead valuators to different conclusions
  - The content of a valuation report, and how that content may inform decisions about next steps when valuator opinions conflict and/or do not comport with stakeholder expectations
  - Advanced discussion of issues related to the treatment of ancillaries in a practice valuation and negotiation for post-acquisition compensation
Key Areas of Appraiser Disagreement

- Standard of Value
- Valuation Methodologies Utilized
- Valuation Model Assumptions
- Physician Compensation
- Use of Equity or Invested Capital Value
- Deal Terms
Standard of Value

- Standard of value should be Fair Market Value as defined in Healthcare

  “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 arm’s 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"
Standard of Value

“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.”
Typical Valuation Methodologies

- **Discounted Cash Flow Model**
  - Values the Practice with regard to future income
  - Income converted to value with a discount rate

- **Asset Approach**
  - Values the Practice with regard to underlying assets
  - Consideration given to tangible fixed assets
  - May be appropriate to consider intangibles
DCF Method Assumptions

- DCF relies on projection for the practice.
- Under FMV forecast should not consider any synergistic or strategic benefits specific to transaction.
  - Revenue Forecast
    - Units of productivity / Growth rates
    - Reimbursement
    - Sources of revenue (technical vs. professional)
  - Expenses
    - Fixed vs. variable costs
    - Labor Assumptions
    - Occupancy expense (rent vs. own)
    - Capital Expenditures
    - Physician compensation and benefits
DCF Method Assumptions

- How are ancillaries modeled in projections?
  - Are ancillaries valued separately or as part of the practice as a whole? If valued separately:
    - Could the practice actually sell the ancillary service line as a stand-alone?
    - Are the assumptions used for ancillary services consistent with the professional practice?
    - Are the risks differentiated between the ancillary practice and the professional practice?
    - Is the physician compensation model consistent with carve out of ancillaries?
Other Ancillary Valuation Issues

- When is it ok to value practice ancillary business separately (if ever)?
- “Customary” Ancillaries vs. “Atypical” Ancillaries
- Lack of adequate financial data (allocation of P&L, no balance sheet)
- Consideration of HOPD rates in valuation
- Regulatory risk – if there is only one utilizer of equipment, does direct valuation of ancillaries equate to valuing referrals?
DCF Method Assumptions

- Should income taxes be applied?
- Discount Rate – consistent with risk in projections?
- Residual value
  - Is the implied long-term growth rate sustainable?
Asset Approach Assumptions

- Assets reflected at book value or appraised at FMV
- Which assets (and liabilities) are included in the appraisal
- Intangible Assets
  - Trade name
  - Medical records
  - Workforce in place
- If valuing intangibles, how is compensation accounted for?
Other Considerations

- Are the values used by the Appraiser reflective of Equity or Invested Capital (assets)?
- Do the appraisals properly reflect deal terms?
  - Stock versus Asset purchase
  - Related party assets/liabilities/leases
  - Asset/liability carve-outs
  - Ongoing negotiations / revisions to terms
- Tax implications of organizational form
- Non-competes
- Post-acquisition compensation model
What are the components of compensation?

- Personal productivity
- Technical profits
- Profits from mid-level providers
What are the components of compensation?

- Personal productivity
  - Evidenced by personally performed, modifier adjusted wRVUs
  - Evidenced by personally generated collections
What are the components of compensation?

Analysis of revenues less direct expenses and a reasonable allocation of overhead

Technical Profits

Allocated amongst the various physicians who utilize the equipment
What are the components of compensation?

- Analysis of revenue less direct expenses and a reasonable allocation of overhead
- Profits from
  - Mid-level Providers
- Allocated amongst the physicians who supervise the mid-level providers
Use of Benchmark Data

- What is reported in the survey data?
- What is common for the specialty?
- Are there other ways to structure compensation to arrive at a similar result?
Benchmark Compensation Data

For AMGA, HHCS, MGMA, and SullivanCotter surveys, the total compensation is reported as direct compensation which may include:

- Salary
- Bonus and/or incentive payments
- Research stipends
- Honoraria
- Profit-sharing
- Clinical medical directorships
- Call coverage
- Voluntary salary reductions

However, the reported data excludes fringe benefits paid by the medical practice (e.g., retirement plan contributions, health insurance).
Avoiding the Double Dip

- Is the technical revenue stream being acquired?
- If not, practice structure plays into compensation options
- Be prepared to help your client explain any differentials between the compensation conclusion and historical compensation
Issues for Hospital Counsel

- The CEO who “wants to get the deal done” . . . and has a track record of “doing what it takes . . .”

- The hospital’s perspective on value (which is not necessarily the same as valuation)
  - Increased revenue from conversion of some services to HOPD
  - Those “sole community provider” DHS services
  - “Value” of retaining the ones who are talking about leaving
Hospital Counsel and Dueling Valuations

- The challenge of multiple valuations
  - What justification is there for throwing one of them out? Do you have to worry about that?
  - What if the CEO wants to mix and match?
- What if hospital counsel has reason to think that unreasonable assumptions are depressing one of the valuations? Inflating one? Should hospital counsel get involved in the assumptions at all?
Special Considerations for the Hospital Counsel

- What if the hospital counsel is being set up to be the bad guy?
  - Physician counsel knows valuation is unreasonable, but wants the hospital’s lawyer to be the one to spoil the mood.
  - CEO knows valuation is unreasonable, but wants to blame it on hospital’s lawyer.

- And that pesky commercial reasonable issue
  - When hospital counsel has to remind the parties that FMV is not enough
Physician Practice Perspective

- Role of physician practice counsel
  - Importance of solid valuation
  - Setting expectations

- Preparing for the negotiations
  - Defining physician transaction and relationship goals
  - Defining deal structure
  - Consistent vs. inconsistent transaction and relationship elements
Physician Practice Perspective

- Pre-valuation
- Valuation process
  - Correct data and information
  - Assumptions and expectations re transaction
    - DCF
    - Asset purchase
  - Assumptions/expectations re going forward relationship
    - Compensation structure
      - Methodology
      - Duration and certainty – initial, updates and adjustments
      - Amount
Physician Practice Perspective

- Process considerations
  - One, two or more valuators?
  - Valuation firm selection and approach

- Report review and comment vs. negotiations
  - Initial ground rules
  - Actual conduct

- Consistent vs. inconsistent facts, assumptions and methods