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Traversing the Threshold of Commercial Reasonableness

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Introduction

In response to the advent of accountable care and value-based reimbursement, which emerging reimbursement models rely on to achieve better outcomes at lower cost, hospitals are increasingly seeking closer relationships with physicians, including direct employment, co-management arrangements, and joint ventures. Corresponding with this growing trend toward hospital-physician alignment is increased federal, state, and local regulatory oversight regarding the legal permissibility of such arrangements. Most notably, there has been more intense regulatory scrutiny related to the Anti-Kickback Statute (AKS) and Stark Laws, especially as they relate to potential liability under the False Claims Act (FCA). Both the Stark Laws and AKS require that any consideration paid to physicians not exceed fair market value (FMV) and be deemed commercially reasonable.

The fraud and abuse laws scrutinize many aspects of health care transactions, including physician compensation arrangements, under both the valuation standard of FMV and the separate, but related, threshold of commercial reasonableness (CR). While analysis of the CR threshold is separate and distinct from the development of a FMV analysis, requiring consideration of different aspects of the property interest included in the transaction, they are related thresholds, and the consideration and analysis of one threshold does not preclude analysis of the other. For example, each element in an anticipated transaction must not exceed FMV if the transaction is to be considered commercially reasonable. Simply meeting the FMV threshold is not, in and of itself, sufficient to establish CR if the transaction does not meet the remaining analytical hurdles (see Exhibit 3, below).

CR elements include consideration of the “…value to the entity paying for…” the enterprise, assets, or services being transacted. On the other hand, the FMV opinion requires that a universe of hypothetical buyers, sellers, owners and investors be considered. For example, consider the acquisition of ten linear accelerators by a purchaser. If the purchaser needs only

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Criminal Indictments</th>
<th>Total Convictions</th>
<th>Total Civil Matters Pending</th>
<th>Monetary Collections (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>282</td>
<td>363</td>
<td>4,010</td>
<td>$1,200</td>
</tr>
<tr>
<td>1998</td>
<td>322</td>
<td>326</td>
<td>3,741</td>
<td>$480</td>
</tr>
<tr>
<td>1999</td>
<td>371</td>
<td>396</td>
<td>2,278</td>
<td>$524</td>
</tr>
<tr>
<td>2000</td>
<td>457</td>
<td>467</td>
<td>1,995</td>
<td>$1,200</td>
</tr>
<tr>
<td>2001</td>
<td>445</td>
<td>465</td>
<td>1,746</td>
<td>$1,700</td>
</tr>
<tr>
<td>2002</td>
<td>361</td>
<td>480</td>
<td>1,529</td>
<td>$1,800</td>
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<td>2003</td>
<td>362</td>
<td>437</td>
<td>1,277</td>
<td>$1,800</td>
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<td>1,002</td>
<td>459</td>
<td>1,362</td>
<td>$605</td>
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<tr>
<td>2005</td>
<td>935</td>
<td>523</td>
<td>1,334</td>
<td>$1,470</td>
</tr>
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<td>2006</td>
<td>836</td>
<td>547</td>
<td>2,016</td>
<td>$2,200</td>
</tr>
<tr>
<td>2007</td>
<td>878</td>
<td>560</td>
<td>743</td>
<td>$1,800</td>
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<td>2008</td>
<td>957</td>
<td>588</td>
<td>1,311</td>
<td>$1,000</td>
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<tr>
<td>2009</td>
<td>1,014</td>
<td>583</td>
<td>1,155</td>
<td>$1,630</td>
</tr>
<tr>
<td>2010</td>
<td>1,116</td>
<td>726</td>
<td>1,290</td>
<td>$2,500</td>
</tr>
<tr>
<td>2011</td>
<td>1,110</td>
<td>743</td>
<td>1,069</td>
<td>$2,400</td>
</tr>
<tr>
<td>2012</td>
<td>1,131</td>
<td>826</td>
<td>1,023</td>
<td>$3,000</td>
</tr>
<tr>
<td>2013</td>
<td>1,013</td>
<td>718</td>
<td>1,079</td>
<td>$2,600</td>
</tr>
<tr>
<td>2014</td>
<td>849</td>
<td>730</td>
<td>2,771</td>
<td>$3,311</td>
</tr>
<tr>
<td>Total</td>
<td>13,441</td>
<td>9,937</td>
<td>31,729</td>
<td>$31,220</td>
</tr>
</tbody>
</table>
AHLA Health Care Transactions Resource Guide

one linear accelerator, purchasing ten, even at fair market value, would not meet the necessity of assets purchased threshold of a CR analysis.8

It is critical to obtain and maintain appropriate documentation so that a transaction can withstand regulatory scrutiny and meet both the FMV standard and CR threshold. Typically, legal counsel does not provide opinions on the commercial reasonableness of a compensation arrangement,9 and will often rely on an independent valuation consultant to provide a certified valuation opinion stating the arrangement does not exceed FMV and meets the requirements of CR. Due to the increase in health care related transactions (see Exhibit 2, below),10 such opinions are becoming an “increasingly important service offered by health-care valuation professionals.”11

Rendering a CR opinion requires that a specific set of core competencies be mastered apart from, but related to, the more traditional knowledge, skill set, and experience that is required when rendering FMV opinions related to the appraisal of the enterprises, assets and/or services being transacted. The key components of a CR analysis include consideration of both qualitative factors that affect the CR opinion and a quantitative analysis of the elements in the anticipated transaction.13

Definitions of Commercial Reasonableness

While definitions of the CR threshold are significantly similar across the various federal agencies tasked with enforcing those regulations, there are subtle nuances between each agency’s interpretation of “commercial reasonableness.” The U.S. Department of Health and Human Services (HHS) has interpreted the term to mean an arrangement that appears to be “...a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals.”14

In addition, HHS’s Stark II, Phase II commentary suggests that: ‘An arrangement will be considered ‘commercially reasonable’ in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician of similar scope and specialty, even if there were no potential DHS [designated health services] referrals.”15

The Internal Revenue Service (IRS) and Office of the Inspector General (OIG) have also provided guidance in defining commercial reasonableness. IRS guidance may be derived from IRS pronouncements on “reasonable compensation;”:

1. “reasonable compensation is...the amount that would ordinarily be paid for like services by like organizations in like circumstances;”16
2. “…reasonable pay is the amount that a similar business would pay for the same or similar services;”17
3. “reasonable compensation [is]...the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances.”18

It should be noted that no IRS pronouncement defining reasonable compensation specifically addresses the health care industry, but they do provide indications as to how the IRS may assess CR thresholds in an anticipated health care transaction.

In 42 C.F.R. § 1001, commonly referred to as the AKS exceptions, the OIG defined a commercially reasonable transaction as one in which “…the aggregate services contracted do not exceed

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Exhibit 2: Volume of Healthcare Transactions12

<table>
<thead>
<tr>
<th>Sector</th>
<th>Q4:14 Deals</th>
<th>Q3:13 Deals</th>
<th>% Change Q4:13 to Q1:14</th>
<th>Q4:13 Deals</th>
<th>% Change Q1:13 to Q1:14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Behavioral</td>
<td>5</td>
<td>4</td>
<td>25%</td>
<td>3</td>
<td>67%</td>
</tr>
<tr>
<td>Home Health Care</td>
<td>19</td>
<td>15</td>
<td>27%</td>
<td>18</td>
<td>6%</td>
</tr>
<tr>
<td>Hospitals</td>
<td>31</td>
<td>20</td>
<td>55%</td>
<td>17</td>
<td>82%</td>
</tr>
<tr>
<td>Labs, MRI, Dialysis</td>
<td>6</td>
<td>8</td>
<td>-25%</td>
<td>9</td>
<td>-33%</td>
</tr>
<tr>
<td>Long Term Care</td>
<td>84</td>
<td>81</td>
<td>4%</td>
<td>65</td>
<td>29%</td>
</tr>
<tr>
<td>Managed Care</td>
<td>4</td>
<td>5</td>
<td>-20%</td>
<td>4</td>
<td>0%</td>
</tr>
<tr>
<td>Physician Groups</td>
<td>16</td>
<td>14</td>
<td>14%</td>
<td>20</td>
<td>-20%</td>
</tr>
<tr>
<td>Rehabilitation</td>
<td>6</td>
<td>5</td>
<td>20%</td>
<td>7</td>
<td>-14%</td>
</tr>
<tr>
<td>Other</td>
<td>36</td>
<td>36</td>
<td>0%</td>
<td>15</td>
<td>140%</td>
</tr>
<tr>
<td>Biotechnology</td>
<td>45</td>
<td>27</td>
<td>67%</td>
<td>32</td>
<td>41%</td>
</tr>
<tr>
<td>e-Health</td>
<td>31</td>
<td>34</td>
<td>-9%</td>
<td>24</td>
<td>29%</td>
</tr>
<tr>
<td>Medical Devices</td>
<td>27</td>
<td>26</td>
<td>4%</td>
<td>30</td>
<td>-10%</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>35</td>
<td>67</td>
<td>-48%</td>
<td>47</td>
<td>-26%</td>
</tr>
<tr>
<td>Grand Total</td>
<td>345</td>
<td>342</td>
<td>1%</td>
<td>291</td>
<td>19%</td>
</tr>
</tbody>
</table>

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those which are reasonably necessary to accomplish the commercially reasonable business purpose of the service.\textsuperscript{19}

**THE CR Analysis**

The CR analysis is comprised of three phases:
1. Ensuring that certain prerequisites for the transaction are met;
2. Developing a qualitative analysis of the transaction, focusing on furthering the business's interest(s); and,
3. Developing a quantitative analysis, focusing on the transaction's financial feasibility.

During each phase, the transaction must overcome various legal and analytical thresholds to achieve a commercially reasonable result. See Exhibit 3 for a graphical illustration.\textsuperscript{20}

**Transactional Prerequisites**

The first step in a CR analysis is to determine if the following two prerequisites are satisfied:
1. All aspects of the transaction do not exceed FMV, and
2. The transaction is sensible in the absence of referrals.

**Fair Market Value**

In the health care setting, the FMV prerequisite requires that the consideration paid for all aspects of the transaction does not exceed FMV. The Health Care Financing Administration (HCFA), now known as the Centers for Medicare and Medicaid Services (CMS), provided the following guidance for determining when payment for services and assets provided does not exceed FMV:

“We intend to accept any method [for establishing FMV] that is commercially reasonable and provides us with evidence that the compensation is comparable to what is ordinarily paid for an item or service in the location at issue, by parties in arm’s-length transactions who are not in a position to refer to one another . . . . The amount of documentation that will be sufficient to confirm FMV will vary depending on the circumstances in any given case; that is, there is no rule of thumb that will suffice for all situations.”\textsuperscript{21} [emphasis added]

**Sensible, Prudent Business Agreement in the Absence of Referrals**

The second prerequisite that must be satisfied in a CR analysis is the determination of whether the anticipated transaction is “...a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals.”\textsuperscript{22}

This requirement applies to the following situations:
1. Rental of office space;
2. Rental of equipment;
3. Bona fide employment relationships;
4. Personal service arrangements;
5. Physician incentive plans;
6. Physician recruitment;
7. Isolated transactions, such as a one-time sale of property; and,
8. Certain group practice arrangements.\textsuperscript{23}
The key aspect of this prerequisite is identifying the role of the physician referral in the transaction. The OIG looks for any financial arrangement that may induce a physician to change his or her referral pattern, such as:

1. “[A]rrangements [to] promote overutilization and…un-necessarily lengthy stays;” and,
2. “[P]ayments to induce physicians…to reduce or limit services to…patients.”

**Qualitative Analysis**

After ensuring that the prospective transaction meets the prerequisites noted above, the second task in a CR analysis is to perform a qualitative analysis of the elements of the proposed transaction. The thresholds involved focus on determining the acquirer’s business purpose(s) and how the anticipated transaction assists in meeting that purpose. The specific qualitative thresholds, as illustrated in Exhibit 4, are:

1. Business Purpose;
2. Necessity of the Property Interest;
3. Nature and Scope of the Property Interest;
4. Enterprise and Organizational Elements;
5. Quality, Comparability, and Availability of the Subject Property Interest;
6. Management Control, Ongoing Assessment, and Other Elements; and,
7. Otherwise Legally Permissible.

**Business Purpose**

The first qualitative threshold that must be analyzed is whether the transaction fulfills a “…business purpose…” for the acquirer. This concept has been expounded upon by the OIG and the IRS as follows:

1. HHS commentary on AKS regulations considers transactions to have a business purpose if they can be “reasonably calculated to further the business of the lessee or acquirer;” and,
2. The IRS defines business activities as those “…carried on for the production of income from the sale of goods or the performance of services.”

**Additional Business Purposes Beyond Net Economic Benefit**

One element that may indicate a sensible, prudent business arrangement is the anticipated profitability resulting from the transaction. The net economic benefits generated from the invested capital may not, however, be the sole business purpose of the anticipated transaction. Additional considerations include, but are not limited to:

1. Expansion into new geographic areas;
2. Expansion into new business lines;
3. Augmenting existing service lines;
4. Diversification benefits;
5. Avoiding costs of establishing offices and facilities, management, and other resources;
6. Operating expense reductions;
7. Increased asset utilization;
8. Greater access to and reduced cost of capital;
9. Horizontal integration;
10. Vertical integration;
11. Management and care protocols;
12. Increased access to technology and innovation;
13. Improved research and development;

These synergistic gains to a specific owner or investor, which would likely not be considered when performing a FMV analysis, may be significant in establishing that a transaction is commercially reasonable.

**Not-for-Profit Entities**

A tax-exempt, not-for-profit entity may, in the accomplishment of its charitable mission, provide non-monetary benefits to the owners/investors of the charitable organization, including taxpayers who act as charitable benefactors to the organization. As such, it is likely that in furtherance of its charitable mission, the organization may generate ongoing financial losses that may be offset by the non-monetary economic benefits accruing to the community provided by the tax-exempt, not-for-profit organization such as increased public health awareness and vaccination efforts.

**Necessity of the Property Interest**

The next threshold that must be overcome in performing a qualitative analysis for a CR opinion is to determine whether “…the items and services obtained…are necessary to achieve a legitimate business purpose of the [employer] (apart from obtaining referrals).” The IRS requires a determination as to whether the consideration paid for the property interest is ordinary (common and accepted in trade or business) and necessary, meaning that which is helpful and appropriate for the trade or business in light of the volume of business handled by the acquirer, such as the number of beds, admissions, or outpatient visits; the complexities of the business; and/or, the size of the organization.

Further guidance from the OIG commentary on the AKS suggests that analysts should determine how the space, equipment, or services meet the “…lessee or purchaser needs, intents to utilize, and…commercially reasonable business objectives.”

**Nature and Scope of the Property Interest**

Next, a determination must be made as to whether the nature and scope of the property interest meets the needs of the acquirer. The IRS has provided guidance as to what would be considered a reasonable business expense for tax purposes, which may be used in determining whether the nature and scope of the assets and services included in the proposed transaction support the necessity threshold, as discussed above. The IRS guidance specifies that the analyst should determine whether the property interest’s cost is:

1. A “cost of carrying on a trade or business;”
2. Undertaken “for the production of income from the sale of goods or the performance of services;”
3. “…[P]aid or incurred during the taxable year;”
4. “...[R]easonable in terms of the responsibilities and activities...assumed under the contract...”
5. “...[R]easonable in relation to the total services received.”

**Enterprise and Organizational Elements**

The IRS pronouncements on reasonable compensation for tax purposes require analysts to make a determination whether the consideration paid for the property interest is “...a sensible, prudent business agreement...” for the acquirer. This determination is made within the context of:

1. “[T]he pay compared with the gross and net income of the business;”
2. The “business policy regarding pay for all employees;”
3. “[T]he cost of living in the locality,” based on an analysis of the “national and local economic conditions;” including whether the acquirer is located in a “…rural, urban, or suburban area;” and
4. The structure, size, and location of the purchaser.

**Quality, Comparability, and Availability of the Subject Property Interest**

Based on the nature and scope of the services provided, those attributes that speak to the quality, comparability, and availability of the services, assets, and enterprises included in the anticipated transaction should be determined. The IRS pronouncements on reasonable compensation for tax purposes takes into consideration “the ability and achievements of the individual performing the service,” including “education;” “specialized training and experience of the individual;” “the history of pay for the employee;” and “...the availability of similar services in the geographic area.” The OIG advises taking into consideration “...the skill level and experience reasonably necessary to perform the contracted services,” especially if “…the services [could be obtained] from a non-referral source at a cheaper rate or under more favorable terms.” Finally, the CFR specifies that “[t]he type, expected life, condition...and market conditions in the area...[for] facilities or equipment...” should be considered, as well as whether “adequate alternative facilities or equipment that would serve the purpose are not or were not available at lower costs.”

**Management Control, Ongoing Assessment, and Other Elements**

Other elements of the transaction that may not fit neatly into the above discussed categories include:

1. The “…quality of management and interdisciplinary coordination.” The government’s expert witness report in U.S. v. SCCCI Hospital Houston Central suggested that health care entities should conduct “a regular assessment of the actual duties performed by the [employee]...[and] it should be clear how effective the [employee] is doing his assigned job and if there is a bona fide need for continuing the services.”
2. In U.S. v. Carlisle HMA, Inc., the judge ruled that health care entities need to determine whether the current “consideration given and received [is paid] under materially different circumstances” than when the contract was entered.
3. The OIG advises that transactions be reviewed to determine if:
   a. “the arrangements flow from an open, competitive request for proposal process...”
   b. “the risk that the arrangements will result in an appropriate utilization...”
   c. “the arrangements are...likely to have a negative effect on patient care;” and,
   d. “the arrangements...have an adverse impact on competition.”
4. A determination as to whether compensation for professional physician services does not exceed the level of collections for those services. In its appellate brief for U.S. ex rel. Drakeford v. Tuomey, the Department of Justice (DOJ) stated: “Obert-Hong dealt with physician compensation arrangements where—unlike the Tuomey arrangements—the physicians did not earn more than their personal collections, and where there was no other basis to presume that the physicians were being paid for actual or anticipated referrals.”

**Not Otherwise Legally Permissible**

Even in the event that a transaction meets all of the foregoing qualitative elements, the transaction may not be considered commercially reasonable if it is not otherwise legally permissible. For example, factors to consider when assessing the legal possibility of the anticipated transaction may be found in antitrust pronouncements by the Federal Trade Commission (FTC), which advises:

1. The anticipated transaction “…is likely to produce significant efficiencies...”
2. “These efficiencies include the provision of services at a lower cost or the provision of services that would not have been provided absent...” the anticipated transaction;
3. The efficiencies achieved as a result of the anticipated transaction “…will benefit consumers”;44
4. The anticipated transaction will help “…monitor and control costs...while assuring quality of care;”
5. The anticipated transaction “…appears likely, on the balance, to be procompetitive or competitively neutral;” and,
6. The anticipated transaction “…would not increase the likelihood of the exercise of market power...because of the existence of the post-[transaction] of strong competitors...”

As noted in the Introduction, other legal edicts that significantly influence health care transactions include:

1. The Stark Law;
2. The AKS; and,
3. The Internal Revenue Code.

While valuation analysts must be versed in the rules and regulations surrounding the industry in which they provide services, they typically do not offer or provide legal opinions. Thus, many CR opinions include a provision that states legal counsel has reviewed the arrangement and considers the proposed transaction to be legally permissible.

Standing alone, a transaction that overcomes the hurdles associated with the qualitative analysis is not yet deemed to be
commercially reasonable; a quantitative analysis must then be conducted as part of the CR determination.

**Quantitative Analysis**
Rendering a CR opinion requires that a specific set of core competencies be mastered apart from, but related to, the more traditional knowledge base, skill set, and experience required in rendering Fair Market Value (FMV) opinions related to the appraisal of the enterprises, assets, and/or services being transacted.91

The post-transaction financial feasibility analysis used in assessing the quantitative factors of an anticipated transaction is similar to an income approach in that it considers projected future net economic benefit streams, as well as an assessment of the risk related to the probability of realizing those benefits streams. However, a CR analysis differs from a FMV opinion in that the former considers:

1. “All consideration to be paid by purchasers and lessees to sellers and lessors,”92 in the aggregate, when projecting future net economic benefit, not just the net economic benefits arising from the individual discrete subject property interests comprising the anticipated transaction;
2. The aggregate projected net economic benefits of ownership or control accruing to a particular buyer, which may include any “unique synergies the … particular buyer would realize as a result of acquiring the asset,”93 not the aggregate projected net economic benefits accruing to the universe of typical buyers, sellers, owners, and investors; and
3. The risk adjusted required rate of return for a particular buyer, inclusive of factors that may not be available under the FMV assumption of a universe of buyers, sellers, owners, and investors, such as:
   a. Operating risk reductions, e.g., decreases in risk that may result from a diverse, multispecialty integrated health system acquiring a focused, single specialty free-standing physician practice;94
   b. Financial risk reductions, e.g., a large integrated health system may enjoy greater access to capital and, thus, a lower cost of capital than a small free-standing physician practice;95 and
4. An economic cost/benefit analysis (e.g., payback period, net present value, and internal rate of return) to determine whether the anticipated transaction makes commercial sense for a particular buyer, not just a single estimate or range of monetary values for the universe of buyers, sellers, owners, and investors.96

When performing a cost/benefit analysis for a particular buyer, a valuation analyst may also wish to consider the value metrics, which result from the application of one or more of the following analytical methods, to serve as a basis for a CR opinion related to an anticipated transaction:

1. Net present value (NPV) analysis, which examines the total expected risk-adjusted future net economic benefits (e.g., present value of the future net cash flows) arising from the total initial economic expense burdens (e.g., initial cash outlays);97
2. Internal rate of return (IRR) analysis, which contrasts an organization’s risk adjusted required rate of return (or hurdle rate) against the discount rate that, when applied to the expected future net economic benefits of the subject property interest, results in a zero net present value;98
3. Average accounting return (AAR) analysis, which determines the average of the net income arising from the assets or services to be acquired in the anticipated transaction for each discrete accounting period, divided by the book value of those subject property interest(s) acquired for each of the corresponding accounting periods;99
4. Discounted payback period analysis, which is similar to a payback period analysis, calculates the number of discrete periods “…until the sum of the discounted cash flow is equal to the initial investment;”100 and
5. Payback period analysis, which calculates the number of discrete periods necessary for “the cumulative forecasted [undiscounted] cash flow [to] equal the initial investment.”101

Each of the value metrics, which results from the cost/benefit analyses described above, should be considered within the context of the qualitative factors of the CR analysis.102 This is especially true when the cost/benefit analysis reflects a financial loss, as a transaction may still be commercially reasonable after the non-monetary benefits that may arise from the anticipated transaction are taken into consideration. For example, the benefits produced by a transaction that result in an expansion into new geographic areas and/or new service lines, or an improvement in the access to technology and/or innovation, may provide substantial evidence of a prudent business decision, i.e., commercial reasonableness.103 In approaching any of these quantitative techniques, it should be noted that tax-exempt not-for-profit health care organizations operate in service to their stated charitable mission and, in lieu of taxes, provide a social benefit, which also may serve as justification for a certain level of financial loss resulting from a cost/benefit analysis of an integration transaction in the aggregate.

**Conclusion**
In this era of provider consolidation and more stringent regulatory enforcement, health care entities and providers should work closely and in a timely manner with competent health care legal counsel and certified valuation professionals to ensure their compensation arrangements meet regulatory thresholds. When prepared by an independent certified valuation professional and supported by adequate documentation, a certified opinion as to whether the proposed transaction does not exceed FMV and is commercially reasonable will significantly enhance the efforts of health care providers to establish a defensible position that their proposed transaction is in compliance. ♦
Disease Services’ Optional Prospectively Determined Payment Rates for Skilled

Register 4867 (1/31/05).


commentary below offers justification for paying physicians at higher rates per


Internal Revenue Service, 11/7/08, p. 136.


in general, the greater the diversity of an asset (or portfolio of assets), the lower


In general, large entities are less risky than smaller entities. For example, see


For a detailed discussion on the qualitative factors of the CR analysis, see
