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HealthCare Appraisers INCORPORATED

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Fair Market Value: Identifying Pitfalls and How to Avoid Them

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Loss of Control
Of Payment Allocation

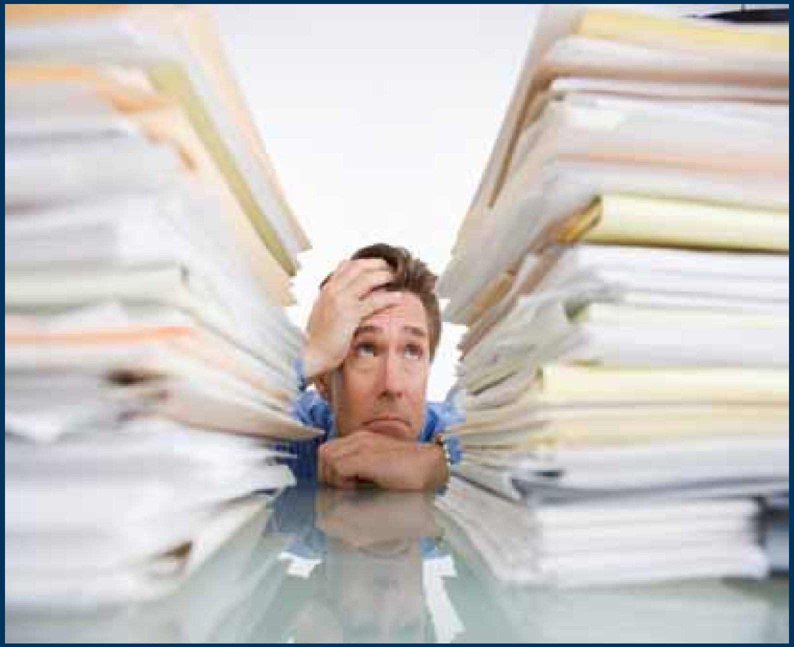
Memorial Health University Medical Center Settlement. Government alleged that Memorial paid above market for administrative services and compensation was ***pooled*** permitting top referral source to obtain disproportionate share of compensation. Memorial Health paid $5,080,000 to settle the case.

Compensation Stacking

Provider entering into multiple compensation arrangements that would be:

i) above a full-time equivalent (1.0 FTE); and

ii) highly unlikely that a physician could perform all duties either because of the number of hours required or for quality reasons.



The "No Risk" Risk Premium

- FMV should not be influenced by the inclusion of gratuitous contract provisions that add "false" risk.
- Examples –
  - Early termination provisions that are not likely to be exercised
  - The perpetual renewal of a one-year lease
  - Leaseback arrangements for space or personnel

Independent Contractors/Medical Directorships

- Use of clinical v. administrative benchmarks.
- Role or number of hours are not reasonably needed or required (i.e., developing arrangement only to “retain” physician in service area).
- Hours worked not documented.

See Exhibit A (Time Card) and
Exhibit B (Monthly Tracking Tool).

Commercial Unreasonableness

- While most conceivable compensation arrangements can be valued, when does an arrangement lack commercial reasonableness?
  - Advertising on physician practice websites by recipients of referrals (*e.g.*, pathology labs)
  - Payment to physicians to coordinate their own on-call schedules
  - Lease arrangements for equipment that should be purchased
  - Hospital transaction costs that exceed the value of the underlying transaction

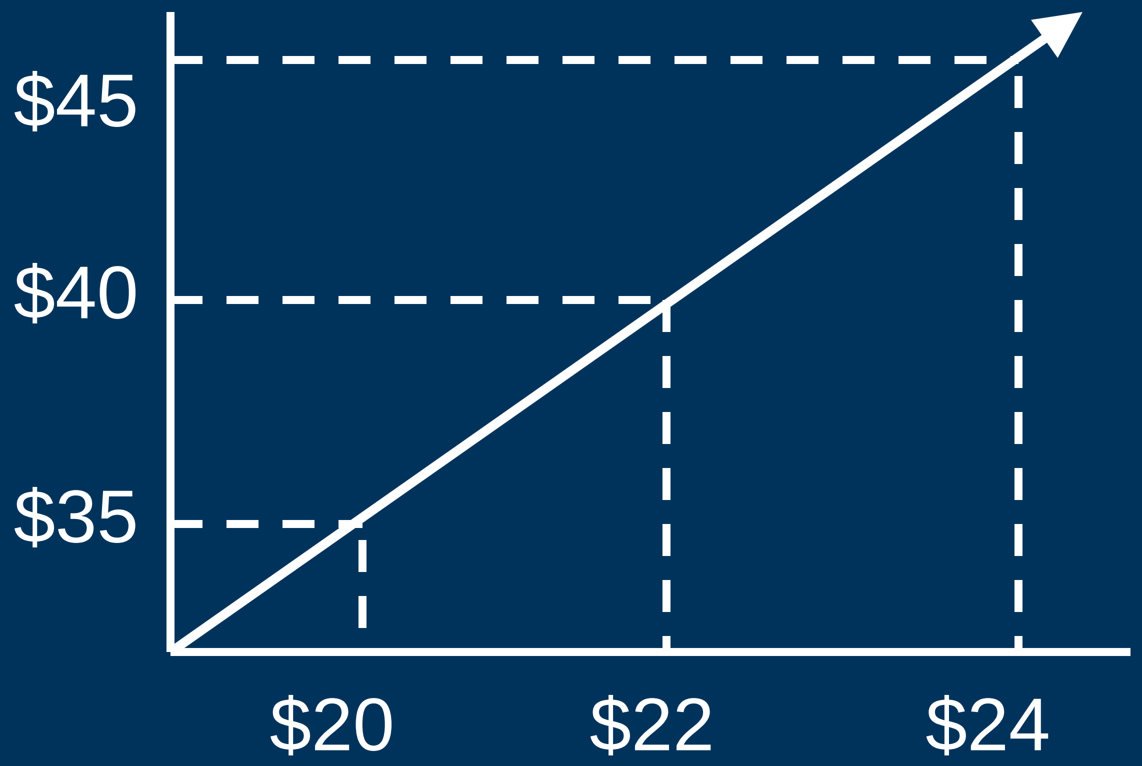
Real Estate: High Risk

- Gross v. triple net lease documentation to support lease amount.
- Incorrect square footage for leased space.
- Hospital/lessor losing money on real estate holdings when most real estate leasing companies in market are generating profit/margin.
- Not charging for increases in maintenance or annual increases when lease contemplated such increases.
- Enhanced tenant improvements not factored into lease rate.

Real Estate: High Risk

- Time share arrangements
  - Not accounting for “vacancy” in time share arrangements.
  - Time share “creep” (i.e., using staff, supplies, or specialized equipment not factored into time share compensation arrangement).

Tenant Improvements Allocations



Per square foot lease rate

The "Behind the Scenes" Management Company

- A physician practice (the "Manager") that engages a third party management company to fulfill the Manager's obligations to a hospital may undermine the arrangement.
  - Both the Manager and the third party management company may seek a "full profit" for their efforts.
  - The Manager may appear to be profiting from arbitrage, or the overall arrangement may appear to be a sham.

Real Estate - Shared Space

- Must allocate all costs
- Rental of space (Half or Full Day Slots)
- Vacancy Rate (Project 20% vacancy?)
- Supplies
- Utilities
- Staff (Registration, Nursing, etc.)
- Equipment

Real Estate
Shared Space - Example

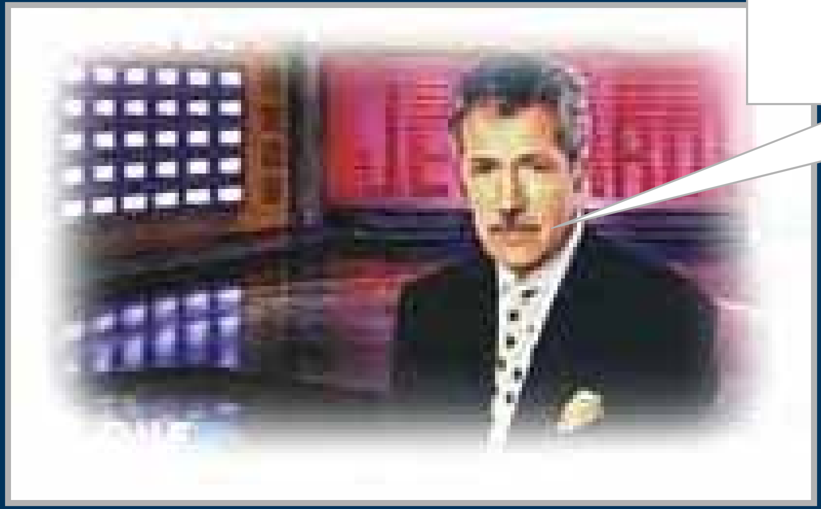
- Assume the following:
- $18 gross per square foot rental (exclusive use)
- 30% projected vacancy
- 1,000 square feet in suite
- Building has 6,000 square feet, with 1,000 square feet for common area (5,000 square feet usable space)
- Suite capable of being leased in half day increments (8:00 A.M. – Noon; 1:00 P.M. – 5:00 P.M.)

Real Estate
Shared Space - Example

- Furniture and equipment in suite determined to be leaseable at $2,000 per year using independent third party leasing company.
- Miscellaneous medical/office supplies projected to be used in suite is approximately $5,000 annually if suite leased 70% of the time

Real Estate
Shared Space - Example

What is the fair market value/commercially reasonable rate for one half day?



Real Estate
Shared Space - Example

- $18 (exclusive use rate) + 30% (vacancy) = $25.71 per square foot ($18 ÷ .7 = $25.71)
- 1,000 square feet (suite) ÷ 5,000 square feet (building not including common area) = 20% (percentage of suite's usable space in building's usable space)
- 1,000 square feet (common area) x 20% (suite to building)
- = 200 square feet (common area allocated to suite)

Real Estate
Shared Space - Example

1,200 square feet (suite plus allocated common area) x $25.71 = $30,852

$30,852 + $2,000 (furniture and equipment) + $5,000 (medical/office supplies) = $37,852

$37,852 ÷ 52 (weeks) = $728 (weekly rate)

$728 ÷ 5 (business days in week) = $146
(daily rate)

$146 ÷ 2 = $73 (half day rate)

Real Estate
Shared Space - Example

Real Estate
Shared Space - Example

Example becomes more complicated if:

- Part of suite is leased (as opposed to full suite)
- Staff is provided by landlord/hospital
- Specialized equipment is used
- Non-standardized supplies are used by a tenant

Preconceived Expectations of Value and Sidewalk Valuators

- The definition of *fair market value* (*i.e.*, the concept of a hypothetical willing buyer and willing seller) is counter-intuitive to the lay person.
- Regulatory guidance regarding use of non-arms length market data causes further confusion
- *Strategic value* is often confused with FMV.
- Physicians' expectations are oftentimes difficult to counter.

Ancillary Revenue

Compensation in an ***employment arrangement*** is based, in part, on ancillary revenue generated by the employed physician’s referrals to employer/hospital.

Example: The specialty of oncology generates substantial revenue from ancillary services.

Misuse of RVUs

- Overview of relative value units (or RVUs)
- Key difference between *total* RVUs and *work* RVUs
  - *Total* RVUs include *work*, *practice expense* and *malpractice*.
- Possible over-counting due to:
  - Assistant at surgery
  - Multiple procedures
  - Midlevel providers
  - Site of service differences

Multiple On-Call Payments

Physicians can be on call at multiple hospitals. However, if the same physician is being paid by multiple hospitals, physician must have dedicated backup for multiple on-call payments to be defensible.

Misapplication of a FMV Opinion

- Examples –
  - Opinion was valid only over a range of outcomes
  - Misapplied “units” (e.g., surgical cases vs. procedures; unrestricted vs. restricted call; 24-hour on-call rate applied to a 14-hour call period)
  - FMV opinion is ambiguous or conditional
  - FMV opinion included critical governing assumptions that were not considered in its application

Reimbursement of Clinical Expenses for Administrative Role

If a hospital has an administrative compensation arrangement with a physician (i.e., medical directorship), hospital should only reimburse expenses that are directly related to the administrative role.

Bad Examples: Clinically-oriented CME, compensation for administrative role when billing for clinical services.

Use of Tainted Market Data

- On-Call compensation - SullivanCotter indicates that only 9% of hospitals establish on-call payment rates through FMV analysis.
  - 57% use a consensus process involving management and physician leadership
  - 41% negotiate individually with each physician/practice
- Virtually all compensated on-call arrangements exist between physicians and hospitals to which they refer

Source: *2008 Physician On-Call Pay Survey Report*, SullivanCotter and Associates, Inc.

Use of Tainted Market Data

- The all time favorite…lithotripsy.
- Virtually no “untainted” market values exist.
- Even once “independent” litho providers founds they needed to JV with physicians to survive.
- A Cost Approach can demonstrate that lithotripsy margins are inordinately high.
- Consequences to a hospital include loss of lithotripsy procedures…and loss of all other procedures performed by urologists.

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National Benchmark Data Mistakes

- Poor alignment of compensation v. productivity
- Use of worked RVUs v. total RVUs
- Employment v. shareholder data – most benchmarks combine, but some benchmark sources separate the data. This is most notable in specialties that generate substantial income from ancillary services. For the specialty of oncology, as reported in the 2008 MGMA Report, the 90th percentile for shareholders is \$966,135 and for employees is \$515,705.