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THE PITFALLS OF FAIR MARKET VALUATION

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We hear the word "fair" a lot these days. We're asked to pay our "fair" share of taxes. We're asked to bear our "fair" share of the sacrifice. Not to go too Ayn Rand on you, but it's painfully obvious that those demanding your "fair" share are also demanding the right to determine what's fair.

Well, then you won't be surprised over the epidemic of "fair" infecting the permitted parameters of agreements between radiology groups and hospitals. Of course, I'm talking about "fair" in the context of fair market value, one of the key elements of healthcare compliance, from federal and state antikickback laws, to Stark and state law prohibitions on so-called self-referral, to the limits of deals entered into by not-for-profit hospitals and health systems.

And you won't be surprised to learn that, in reality, the fair market valuation process often is hardly fair, blind to value, and generally ignores the true market. In a sense, it's simply Orwellian doublespeak. Well, that's not exactly true, because it has a tremendously real impact on the level of coverage stipend support

paid to radiology groups and, therefore, on the amount of radiologist compensation, and that impact is negative.

The hospital-valuation consultant complex

You're likely familiar with the term military-industrial complex used to portray the cozy relationship among politicians, defense contractors, and the armed forces. It describes the fact that the defense industry and its players give political contributions to politicians who then endorse defense spending, which results in purchases by the armed forces from the defense industry.

Due to the expanded scope of compliance laws turning on the issue of fair market value, and the increasing trend of hospital-physician transactions such as exclusive contracts with stipend support, hospital acquisition of physician practices, hospital employment of physicians, and the push toward so-called hospital-physician alignment such as accountable care organizations (ACOs), the relationship between hospitals and health systems, the large purchasers of valuation services, and the large valuation consulting firms selling those services, has tightened.

Hospitals and their executives rely on valuation opinions to avoid prosecution for violating the law and are willing to pay for those defensive opinions.

Consultants desire the substantial fees they charge hospitals for the rote number crunching they perform -- in a very real sense they actually do understand value, at least in respect of their services, in that they take a relatively small amount of labor and sell it for the value it truly represents: the value of safety for their clients.

But at the same time, they are overly cautious to cover their own behinds in terms of an improper valuation opinion -- this leads to nonsensical ceilings on opined value to build so much safety into the opinion that it becomes something other than a true valuation of your services.

And here's the kicker: Hospitals and their administrators are happy to receive the by-product, a valuation that fits well below the full amount of the compensation or support that they would otherwise have to pay if the market were truly analyzed.

It's uncertain whether hospitals actively encourage this level of "safety" or whether they are merely happy to receive its benefits, but either way it creates a false ceiling that ignores fairness, value, and the actual market.

The 75th percentile

This over cautiousness causes valuation consultants to often state that they never opine as to the bona fides of a deal at more than the 75th percentile of value as reported on national, or large-area regional (for example, "Western") studies. Of course, some valuation consulting firms conduct their own studies and sell that information to those same hospital clients.

Think about this for a minute. In order for the 75th percentile to exist, there must be a top value and the other values that are found in the fourth quartile, the highest quartile. Those fourth quartile values cannot simply be assumed to be outside the realm of actual fair market value. Yet valuation consultants ignore the existence of that top quartile, which must exist to determine the 75th percentile maximum to which

they will opine!

So to recap:

- The hospital gives the consultant money for the valuation opinion.
- The consultant gives the hospital protection in the form of a valuation opinion as to fair market value.
- And the consultant gives the hospital the benefit of a valuation that ignores everything above the 75th percentile -- in other words, it relieves the hospital of the burden of paying anything above an arbitrary cap.

The compensation death spiral

As if the present impact of artificially capping the market is not bad enough, let's look at its effect as that process continues to play out over time.

We'll start with a prototypical radiology group, Oak Tree Radiology, that's negotiating with Community Hospital over the amount of a coverage stipend in connection with the renewal of its exclusive contract.

Setting aside all of the strategic issues in respect of maximizing stipend support, the valuation consultants engaged by Community Hospital opine that the 75th percentile of compensation gleaned from averaging national compensation surveys is $X. The consultants are adamant that they won't opine as to a value greater than the 75th percentile. Community Hospital agrees to pay Oak Tree Radiology a coverage stipend based on $X as the fair market value in connection with the 2011 renewal.

During 2011, these valuation consultants and their competitors are all referencing the same national

compensation surveys and they're all pointing to somewhere near $X dollars as the 75th percentile and, therefore, as the maximum per-physician compensation they will bless in their valuation opinions.

With exclusive radiology contracts generally having a two- to three-year term, by 2013 or 2014, at the time that Oak Tree Radiology and Community Hospital are negotiating the stipend support for their subsequent exclusive contract, due to the prevalence of deals in effect from 2011 to 2013 at the $X maximum, the national compensation surveys relied on by Community Hospital's valuation consultants now indicate that $X-Y dollars is the new 75th percentile. In other words, due to the prevalence of valuation opinions at $X dollars three years prior, $X is now at the top of the range in the fourth quartile and can no longer be justified in terms of the protection that valuation consultants seek in issuing their opinions. In its place comes the new 75th percentile, $X-Y.

Of course, flash forward another two or three years and the 75th percentile is now well below $X-Y. And the cycle starts all over again, and again and again.

I once thought that if this continues unabated, radiologists will eventually be working for a bag of peanuts. But then I realized that if valuation opinions are still essential at that point in time, it's more likely to be for three-quarters of a bag.

What you must do

If you'd like to create a better future for your group in respect of "fair" stipend support, there are steps that you must begin to take at the micro, or group, level.

To begin, you need to understand and appreciate that a strategy in connection with stipend support can't be separated from your group's strategy in respect of the entire contractual relationship with a hospital. And that contracting strategy must be consistent with your group's overall business strategy.

As is the case in respect of any strategic issue of this complexity, it takes considerable time and effort to deploy the required tactics. This includes significant research as to the definition of the relevant market, the development of supporting data, the complete understanding of the valuation process, and the complete understanding of the ways and ways not to present data in response to a valuation request, among others.

Of course, on a national level, the hospital-valuation consultant complex deserves scrutiny at the highest level. I am in the process of gathering information from readers like you as to experiences with artificial caps on valuations for the purpose of a follow-up article and would appreciate your assistance -- please see the contact information below.

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