Fair Market Value Versus Strategic Value

Karin Chernoff Kaplan, Director, Veralon **Denise Palencik**, Sr. Associate, Veralon

In evaluating the fair market value (FMV) of healthcare entities, we often are asked why we do not adjust the revenue stream of the business being evaluated to reflect the payment rates of the potential buyer. The answer is based on the Stark and Anti-Kickback statutes, and in the difference between FMV and strategic value.

These statutes dictate that transactions involving hospitals and health systems receiving payment from federal programs must be completed at FMV.

Phase II of the final Stark II regulations, issued in March 2004, defines FMV to mean "the value in arm's-length transactions, consistent with the general market value."

These same regulations define "general market value" as:

The price that an asset would bring as a 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.

FMV therefore requires consideration of a *hypothetical* buyer and seller. In contrast, strategic value is the value to a *specific* investor.

The question of adjusting the revenue stream of the business being valued is most often raised when the seller includes physicians and the buyer is a hospital or health system. From the physicians' point of view, it's a compelling argument: The hospital or health system may generate higher profits from the business based on the organization's fee structures and other factors, so why shouldn't that potential profitability be reflected in the valuation? Why shouldn't the owner(s) of the subject business benefit from that as well?

Unfortunately, including the potential buyer's payment rates violates a key requirement in determining FMV: the concept of the hypothetical buyer. By substituting the payment rates of a specific buyer, the standard of value changes from FMV to strategic or investment value, raising compliance red flags.

There is no rule against a buyer considering the strategic value to the organization—i.e. calculating the value the organization might obtain based on its fee schedules—but this analysis must be distinct and separate from the valuation process.

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The hypothetical buyer is not a specific entity; it is any possible buyer of the business. The universe of hypothetical buyers includes not only hospitals and health systems, but also independent physicians and nonclinical businesspersons. Therefore, the hypothetical buyer does not necessarily have the same negotiating power as hospitals and health systems to receive higher payments from third-party payers. (Looked at another way, if the current owner of the business could not negotiate these preferable payment rates, why would the hypothetical buyer be able to do so?)

To ensure regulatory compliance in an acquisition, healthcare executives and legal counsel must verify that the correct standard of value is applied.

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877.676.3600 www.veralon.com info@veralon.com