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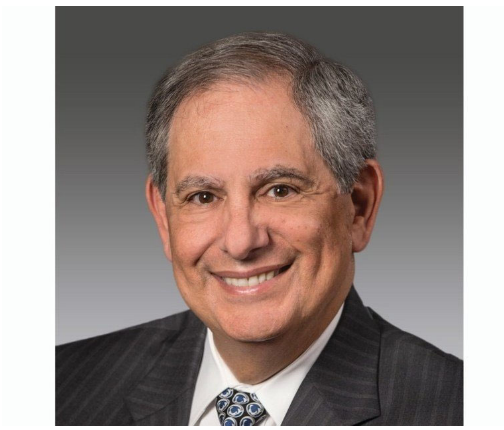
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COMMENTARY

How to Define Fair Market Value Rate of Return in Health Care Agreements

Multiple issues surround fair market value and performing the appropriate analytical steps. In addition to fair market value, most applications of the anti-kickback statute and Stark law also require commercial reasonableness.

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By David Glusman

When legal counsel is looking at relationships between health care entities subject to anti-kickback or Stark law rules, fair market value will come into play. Multiple issues surround fair market value and performing the appropriate analytical steps. In addition to fair market value, most applications of the anti-kickback statute and Stark law also require commercial reasonableness.

One of the relatively critical issues that is often overlooked or misapplied is determining an appropriate rate of return. As described below, once the rate of return is properly determined, it can be applied to several issues including the actual funds at risk, the length of time the funds might be invested and continue to be at risk, changes and risk overtime, and other factors.

In general, determining the appropriate rate of return, which is normally done by the valuation professionals or internal financial staff at one of the health care organizations, will be based on market interest rates, with little or no risk matching the term of the agreement. Normally, Treasury bill rates are used as a target for this. The valuation model will then take into account additional items including the historic stock market additional rate of return, industry-specific incremental or decremental factors, as well as issues specific to the entities involved, and additional risk factors. These may include the stability of the entities, whether they have an operating history, and profitability. Additional items that would be considered include the management capabilities of the entities and outside factors such as regulatory or legislative risks.

In health care, there are a multitude of risks on the horizon, some known and some unknown.

By way of example, a management services organization being formed by a health care system on behalf of a start-up entity with very little management experience would have far more risk than a similar agreement where the management services are being performed for a competent, experienced, multi-year team. The amount of new investment by each of the parties is also a consideration. If the management services organization (MSO) has the majority of the capabilities in place, there is less risk on that side. Likewise, if the organization being serviced is making a significant capital investment that will provide for more stable and more secure operations and the likely ability to pay the MSO fees, this would reduce risk and reduce the appropriate rate of return.

Additional considerations include the length of the agreement. Legal counsel generally will require that any agreement be for at least one year, in order to comply with the anti-kickback and Stark regulations. The longer the agreement, the more you must consider its term in assessing risk. In some agreements, a long term will yield a lower risk, as the management services organization will have more time to recover its initial investments, if any. A longer timeframe may also, in some circumstances, bring the possibility of greater risks into play. The determination of the length of term must be considered by both legal counsel and management of the two organizations. All these factors weigh heavily in determining the correct fair market value analysis that is to be performed.

Determining the Rate of Return Example

The methodology for determining the rate of return is generally the same as the business valuation methodology.

- The first step is to determine a risk-free rate of return. Most experts consider Treasury bills to be the standard. The 10-year Treasury bill rate would be selected as of the valuation date. The valuation date is an important issue for all valuation-related work and should be used for the date of the investment or the start of the proposed arrangement.
- The next step is to determine an equity risk premium, as if the arrangement is based on ownership.
- Step three is to determine an appropriate size premium: what is the size of the financial arrangement compared to the equity market in general (upon which the equity premium rate is based).
- The last step is the broadest: determining the company-specific rate adjustment.

The calculation will look like this:

Subject Company Development of Discount Rate As of Jan. 1, 2020

Risk free rate 1 + 2.25%

Equity risk premium 2 + 6.17%

Size premium 3 + 8.02%

Specific-company risk premium 4 + 10.00%

After-tax discount rate = 26.44%

Note 1. Information provided by the Federal Reserve Board. The rate reflects the 20-year constant maturity rate of return on U.S. Treasury Bonds as of Jan. 1, 2020.

Note 2. The equity risk premium was reported in Duff & Phelps Valuation Handbook, Guide to Cost of Capital, 2019. This figure reflects the supply-side equity risk premium. The supply-side premium is a forward-looking estimate of the equity risk premium that accounts for the change in the price/earnings multiple of the S&P 500 Index throughout recorded history. We have used the supply-side equity risk premium as it best represents forward-looking investor expectations.

Note 3. Reflects size premium for a portfolio of small public companies utilizing a size premium as reflected in the 2019 Duff & Phelps Valuation Handbook—Guide to Cost of Capital for the 10th Decile (10b). Elected to use decile 10b due to the fact the market value of company is well below the average of those companies in decile 10a.

Note 4. Specific company risk premium based upon our assessment of the company's financial and business risks over and above those captured under the size premium. In recognition of the lack of business management experience and overall risk factors, we utilized a higher company specific risk

In summary, the rate of return is an important and sometimes overlooked analytical component of determining the appropriate terms of management services and other agreements in health care organizations. The methodology described above, or some other reasonable standard and industry accepted methodology, should be used as part of determining an appropriate rate of return in health care arrangements subject to anti-kickback regulations.

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