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Employed physician compensation: Expense or investment?

By Darcy Devine, AVA, AIBA

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A common assignment for a health care valuation consultant is to review a proposed employment agreement between a hospital (employer) and a physician (employee) and determine whether the compensation described in the agreement is consistent with fair market value (FMV). In addition to reviewing the agreement from an FMV perspective, valuation consultants are often asked to assess whether the proposed arrangement is commercially reasonable.

These reviews are very important components of a hospital's compliance efforts. Hospitals are employing physicians on an ever-increasing basis. The Stark laws require that the compensation

hospitals pay to employed physicians is FMV and is part of a commercially reasonable agreement. These are separate and distinct determinations for the valuation consultant to make, because employment compensation that meets the FMV standard may not necessarily be part of a commercially reasonable agreement, and vice versa.

Determining the FMV of a physician's services presents its own challenges, but there appears to be even more uncertainty and inconsistency in the health care valuation industry related to commercial reasonableness opinions. Part of the challenge is the limited guidance that has been provided by the Centers for Medicare and Medicaid Services (CMS) regarding the definition of "commercially reasonable" and what constitutes a commercially reasonable arrangement for physician services. Below is a summary of the guidance that appears in the Stark regulations:

■ We are interpreting "commercially reasonable" to mean that an arrangement appears to be a sensible, prudent business

agreement from the perspective of the particular parties involved, even in the absence of any potential referrals.¹

- With respect to determining what is "commercially reasonable," any reasonable method of valuation is acceptable, and the determination should be based upon the specific business in which the parties are involved, not business in general.²
- In the absence of referrals, an arrangement will be considered "commercially reasonable" if the arrangement would make commercial sense when entered into by a reasonable entity of similar type and size and a reasonable physician (or family member or group practice) of similar scope and specialty, even if there were no potential DHS referrals.³

In the absence of a safe harbor or universally accepted methodology, the valuation consultant—using generally accepted approaches to valuation—must find a logical approach to determine what is commercially reasonable and then support his/her findings (See box on page 58). A good starting point when reviewing a physician employment arrangement is to find out the purpose of the arrangement (i.e., Why is the physician being employed?) and evaluate the commercial reasonableness of the arrangement with that purpose in mind.

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As a financial investment

For example, one way to determine commercial reasonableness is to look at a physician employment arrangement as a financial investment and decide whether or not, in the absence of referrals, it is a good one. This approach works if the primary purpose of the arrangement is to produce financial returns for the hospital employer. In this scenario, benefits from the arrangement must exceed costs for a “go” versus a “no go” investment decision. The analysis consists of projecting professional collections, operating expenses, and physician expenses and then determining whether the professional services of the physician generate positive cash flows for the hospital. It is easy to argue that a rate of return in excess of the hospital’s minimum acceptable return on an investment (i.e., its hurdle rate) would make the employment arrangement commercially reasonable.

The problem with this approach is that market research data indicate that the “profitable” hospital-owned physician practice is a rarity. Survey reports published by the Medical Group Management Association (MGMA) show that the median net income/loss for a hospital-owned family practice is a loss of \$124,807 per full time (FTE) physician. For hospital-owned internal medicine practices, the median loss is \$219,959 per FTE physician; for

hospital-owned multi-specialty practices, the median loss is \$190,626 per FTE physician. Considering this data alone, hospitals should not expect meaningful financial returns when employing physicians. Understandably, it is difficult to prove that these arrangements are commercially reasonable when analyzing them from a purely financial investment perspective.^{4,5}

As a necessary expense

A second way to determine commercial reasonableness is to look at a physician employment arrangement and determine whether or not it constitutes a good and necessary expense for the hospital. This approach is especially appropriate if the rationale for the employment arrangement is that it helps

the hospital meet the IRS’s community benefit standard for tax-exempt status or maintain compliance with other laws. An argument can be made that the employment arrangement, viewed as an expense, makes commercial sense and is a necessary cost of doing business, if the arrangement accomplishes one of these goals at a cost that is less than or consistent with other alternatives (e.g., entering into professional services arrangements with private practice physicians or recruiting new physicians to a start-up practice).

For example, the Patient Protection and Affordable Care Act (PPACA), enacted in 2010, requires that tax-exempt hospitals conduct a community health needs assessment (CHNA) every three years and adopt an

Generally accepted approaches to valuation

Cost approach. A general way of determining a value indication of an individual asset by quantifying the amount of money required to replace the future service capability of that asset.

Income (income-based) approach. A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.

Market (market-based) approach. A general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.

Source:

BV Resources, International Glossary of Business Valuation Terms

implementation strategy to meet the identified community health needs.⁶ These assessments will likely need to identify any community shortages of primary care physicians and specialists who accept Medicare, Medicaid, and uninsured patients and find solutions for addressing those shortages. Accordingly, fair market value compensation paid to a physician under a hospital employment arrangement may also be commercially reasonable—even if the physician’s medical practice generates a financial loss—if that arrangement helps secure or improve access to care for the Medicare, Medicaid, and uninsured populations. This may also be true for situations in which an existing non-employed physician (1) is a roadblock to recruitment in his/her specialty, (2) won’t participate in succession planning for his/her practice, and/or (3) will not cooperate with hospital initiatives (such as quality reporting, etc.). In these situations, it may be commercially reasonable to employ the physician (assuming that he/she will comply as a result of employment), even though the medical practice won’t generate a profit.

In any of these situations, providing a description of community benefits stemming from the physician employment arrangement and any uncompensated care the employed physician provides in its

CHNA could be instrumental in the hospital’s efforts to maintain a tax-exempt status and could show that the arrangement is a commercially reasonable expense. Supporting documentation for the commercial reasonableness review would include analyses of the external market factors (e.g., a national or regional physician shortage, physician compensation benchmarks, recruitment offers being made to comparable physicians) that help defend the amount of compensation paid to the employed physician and show that more cost efficient alternatives were not readily available.

Another example of a physician employment arrangement that may be commercially reasonable (from the expense perspective, not the financial investment perspective) is one that does not produce a profit (from a medical practice standpoint), but does help the hospital-employer comply with the Emergency Medical Treatment and Active Labor Act (EMTALA). It stands to reason that if an employed physician’s professional services generate a loss for the medical practice, his employment arrangement could still be considered commercially reasonable, if his employment resulted in emergency coverage for a new specialty and/or reduced on-call payments to independent contractors by a substantial amount. Further evidence of commercial

reasonableness would include data showing that the quality, consistency, and/or reliability of call coverage improved because of the employment arrangement.

Conclusion

The commercial reasonableness of a hospital/physician employment arrangement can be determined from at least two different points of view: one in which the arrangement is viewed as a financial investment or one in which it is viewed as an expense. If the arrangement is viewed as a financial investment, it would need to produce some minimum rate of return to be deemed commercially reasonable. If the arrangement is viewed as an expense or a cost of doing business, it would need to be proven necessary and would need to be comparably priced or less costly than acceptable alternatives to be considered commercially reasonable.

These are just two examples of ways in which health care valuation consultants can assess commercial reasonableness. Furthermore, as previously noted, CMS has indicated that any reasonable method of valuation is acceptable, thus implying that there are many other valid approaches, including those that seek to quantify the value of the community benefit (such as increased access to quality care) that can come from

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Employed physician compensation: Expense or investment?

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hospital/physician employment arrangements. Regardless of the approach used, a commercial reasonableness analysis requires an understanding of the purpose of the arrangement being reviewed; acknowledgement of the relevant facts and circumstances of the situation; and an appreciation of the unique requirements and needs of the hospital, the physician, and the community involved. ■

- 1 Federal Register / Vol. 63, No. 6 / Friday, January 9, 1998 / Proposed Rules
- 2 Federal Register / Vol. 66, No. 3 / Thursday, January 4, 2001 / Rules and Regulations
- 3 Federal Register / Vol. 69, No. 59 / Friday, March 26, 2004 / Rules and Regulations
- 4 Medical Group Management Association, Cost Survey for Single-Specialty Practices: 2010 Report Based on 2009 Data
- 5 Medical Group Management Association, Cost Survey for Multi-Specialty Practices: 2010 Report Based on 2009 Data
- 6 U.S. House of Representatives, 111th Congress, 2d Session PRINT 111-1, Compilation of Patient Protection and Affordable Care Act, U.S. House of Representatives, May 2010



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