The Pandemic's Effect on Physician Practice Transactions: Valuation Issues, Differing Buyer and Seller Expectations, and the Rise of Transaction-Related Anti-Kickback Risk

By Ari J. Markenson, J.D., M.P.H., Venable LLP, New York, New York, and Jerry M. Chang, C.F.A., Ankura Consulting Group, LLC, Atlanta, Georgia

Introduction

The transaction marketplace for physician practices is incredibly active for physician owners, transaction lawyers, financing sources, consultants, tax advisors, and many other stakeholders. Whether it's health systems and hospitals acquiring or divesting primary care and specialty practices or private investment firms consolidating practices through large practice management services structures, the medical practice transaction ecosystem is very dynamic.

Varying business reasons motivate each market participant's activity, but it adds to a frenzied environment in the aggregate. Health systems are either trying to create integrated care models, address weakness in hospital emergency department and inpatient businesses, control the "gatekeepers," and/or exit practice acquisitions that are underperforming expectations. Private investment firms are finding significant opportunities in a sector of the health care industry that is still quite fragmented with room for consolidation and efficiencies. Physician owners who weathered the pandemic-related operational issues are finding a "sellers" market with an opportunity to exit the management headaches of practice management.

Overall, this increased activity brings with it several major deal-related issues. The "seller's" market and the effects of the pandemic are bringing into focus questions around the most appropriate way to value practices and structure transactions. The pandemic has increased uncertainty around getting a clear picture of a practice's current and future financial performance. Elevated financial performance uncertainty has led parties to enter into transaction structures and terms to bridge differences and mitigate perceived risk. At least one of those ways may carry significant legal risk under the federal Anti-Kickback Statute, 42 USC 1320a-7b(b) (AKS).

Valuation

The science and art of valuation related to physician practice business and asset transactions has rarely been tested more than during the past two and a half years. Those who approached valuation in the past with a simplistic, mechanical mindset were quickly reminded about the importance of understanding the nuances of valuation principles when the "normal" environment drastically changes.

In most industries, the consequences of disregarding these nuances can lead to material overpayment or underpayment for a business and its related assets. However, in the heavily regulated healthcare industry, a valuation miss can have more than economic consequences—it can also result in increased regulatory and tax compliance risk.

It is impractical for this article to cover all valuation and transaction structure issues that emerged more prominently during the pandemic. However, below are two key valuation considerations that may not have had much focus before the pandemic's disruption of the marketplace.

Is the Premise of Value Appropriate?

In the healthcare industry, most understand and focus on the importance of fair market value as the standard of value for regulatory compliance. A concept that garners less attention is the *premise of value*. Various premises of value may be considered under the fair market value standard. In general, four premises of *value* are typically considered:[1]

> *Value-in-Continued-Use, as Part of a Going Concern*
> Value-in-continued-use, as a mass assemblage of income-producing assets, and as a going concern business enterprise.
>
> *Value-in-Place, as Part of a Mass Assemblage of Assets*
> Value-in-place, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise.
>
> *Value-in-Exchange, in an Orderly Disposition*
> Value-in-exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of an orderly disposition. This premise contemplates that all the business enterprise's assets will be sold individually and that they will enjoy normal exposure to their appropriate secondary market.
>
> *Value-in-Exchange, in a Forced Liquidation*
> Value-in-exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of a forced liquidation. This premise contemplates that all the business enterprise assets will be sold individually and that they will experience less than normal exposure to their appropriate secondary market.

One could conceivably have four different fair market value conclusions depending on the selected premise of value. The selected premise of value related to a fair market valuation analysis can have material implications on identifying assets to be valued, methodology, and key assumptions utilized. Choosing the appropriate premise of value is critical considering the impact of the pandemic.

The pandemic caused many healthcare practices to become distressed, especially smaller practices. A question for a potential buyer to consider: is the medical practice a going concern business on a standalone basis, or should a different premise of value be considered, such as value-in-place or liquidation value? The answer has implications for the methodology and critical assumptions utilized.

For example, if a value-in-place or liquidation premise is assumed, the valuation of certain intangible assets may not be appropriate (e.g., assembled workforce, goodwill). In a situation where the provider business will likely close, a truncated projection reflecting a wind-down may

be necessary to perform a Discounted Cash Flow method. A probability-weighted scenario analysis assuming different premises of value could be an option in estimating fair market value.

Impact on Selected Valuation Approaches and Methodology

The three approaches to business valuation (i.e., asset, income, and market) are predicated on future earnings streams generated from a business or the sale of related assets. Under the asset approach, the business value is the price at which its tangible and intangible operating assets could be sold. Under the income approach, the business value is the present value of the expected future earnings generated from using these assets. Under the market approach, the stock prices of publicly traded companies or the price that an acquirer pays for a business or asset are based upon the investor's expectations of future earnings or proceeds, respectively.

Because valuation is forward-looking, historical results and trends are only helpful as a potential indicator of future earnings. Due to the impacts of the pandemic, future earnings of most healthcare businesses will likely be drastically different than historical pre-pandemic earnings. Therefore, valuation multiples based on historical results will not be appropriate in most cases.

Market Approach

The two primary methods under the market approach are the Comparable Transactions (CT) Method and the Guideline Public Company (GPC) Method. Under the CT Method, valuation multiples from historical completed transactions involving comparable companies are applied to the subject company. For the GPC Method, valuation multiples for publicly traded comparable companies are calculated using the public company stock prices. For both methods, comparability of the guideline transactions and companies and confidence in both the numerator (price) and denominator (financial metric) are essential in deriving valuation multiples. Each of these variables will be more uncertain in a pandemic-affected environment, and certain earnings adjustments must be made.

Because the local market and demographics highly influence healthcare, the market approach in healthcare valuation is often utilized as a reasonableness check to the income approach. Even within a local market, practices with different payer mixes can have widely different financial and operational characteristics. Given the pandemic's impact, relying upon a market approach is even more challenging due to the scarcity of transactions and the increased need to make comparability adjustments to the healthcare provider business or asset being valued.

For the CT Method, this challenge of comparability becomes heightened during a sharp economic downturn with wide-ranging and varied local market impact. Even if transactions for comparable companies or assets can be located, these transactions occurred in the past during very different economic times, and acquiring entities most likely had very different growth expectations compared to the current market.

For the GPC Method, the valuation multiples are based on the public company stock prices, which should incorporate the economic downturn and resulting investor expectations. However, current stock prices may be artificially depressed and not representative of the long-term prospects for comparable companies.

Additionally, the buyer should emphasize the projected revenues and earnings of the public companies and consider calculating valuation multiples based upon those forward-looking metrics rather than the last twelve-month metrics. These projected revenues and earnings would incorporate the company's expectations, considering the pandemic.

Income Approach

The Discounted Cash Flow (DCF) Method and the Capitalized Cash Flow (CCF) Method are the primary valuation methods under the income approach. Under the CCF Method, normalized earnings are capitalized into the future, assuming an estimated discount rate and a constant level of growth. For the DCF Method, the projected cash flows are discounted back to a present value utilizing an estimated discount rate. Mathematically, the CCF and DCF Methods are similar, except that the CCF Method assumes a constant growth rate, whereas the DCF Method allows for variable growth rates in the short term.

Since the CCF Method determines a value based upon a single earnings period, the calculation of normalized earnings is critical. In these uncertain and volatile times, the number of adjustments and level of normalization necessary to arrive at a single earning period considering the uncertainty related to future expected cash flow, the timing of those cash flows, and risk factors would contribute to the weaknesses of this methodology and likely make it impractical.

The DCF Method is often the preferred valuation method for healthcare valuation, given that this method is best equipped to incorporate the specific business's expected cash flow, the timing of those cash flows, and risk factors. The advantages of the DCF method become even more pronounced given the current and future expected uncertainty and volatility that companies face today. Earnings are projected for each discrete period in the short term, allowing flexibility to factor in risk through the derivation of the discount rate, sensitivity analyses, and probability-weighted scenarios. During "normal" economic times, it is challenging to project a healthcare provider's cash flows, and the pandemic further complicates the inherent complexity of valuation.

Asset Approach

For healthcare valuations, the asset approach is typically glossed over, as the income and market approaches more appropriately capture the value of a going-concern business. However, as stated earlier, there will be more financial stress on already distressed healthcare organizations, and some healthcare provider businesses may need to be valued under a different premise of value. Therefore, in this environment, there may be an increased number of transactions where an asset approach indication of value should be relied upon for the conclusion of value.

Below is a summary of the pandemic's general effect on the three approaches to value:

Three valuation approaches	Description and applicability in current climate
1. Market Approach	• Comparable Transaction Method or Guideline Public Company Method • ***More challenging during periods of heightened uncertainty so may be viewed as corroborative or sanity check***
2. Income Approach	• Discounted Cash Flow Method • ***Typically most preferred valuation method, particularly during "Black Swan" events like the COVID-19 pandemic*** • ***Key assumptions such as valuation date, premise of value, and geographic considerations are even more important.***
3. Asset Approach	• Net Asset Value Method • More applicable to very asset intensive businesses • ***May become more applicable as companies are in financial distress like the current COVID-19 environment***

Source: Ankura Consulting Group

Naturally, many physician owners looking to sell their medical practice or group will object to an offer that reduces or neglects any business or intangible asset value due to the effects of the pandemic. These owners will appeal to their practice's pre-pandemic historical performance and argue that their practice volume and margins will "bounce back" to pre-pandemic levels and return to its previous growth trajectory. This could be true but should not be assumed.

Diverging perspectives will expectedly cause differing buyer and seller risk/return expectations resulting in disagreements on value and price. The buyer and seller may attempt to mitigate perceived risk to get a deal done by utilizing common transaction pricing structures such as earn-outs. However, one must be aware of the regulatory risks inherent in an earn-out structure in the healthcare industry.

Earn-Outs and Risk under the Federal Anti-Kickback Statute, 42 USC 1320a-7b(b) (the "AKS")

Parties to physician practice acquisitions that involve direct or indirect connections to federal health care program (FHCP)[2] business often must evaluate the transaction structure to determine whether it may implicate risk under the AKS. That review is not a new issue. The use of earn-outs in transactions is not new either; parties to transactions have often looked to earn-outs to bridge specific valuation issues or address other transactional concerns. However, the valuation issues mentioned above, coupled with a growing and increasingly ultra-competitive market for physician practice deals have created a scenario where earn-outs are more likely to be a part of the negotiation than not. The increase in both the interest and actual use of earn-outs has simply multiplied the need for appropriate analysis of the earn-out structure and whether it might create AKS risk.

The AKS makes it a criminal offense to knowingly and willfully offer, pay, solicit, or receive any remuneration to induce, or in return for, the referral of an individual to a person for the furnishing of, or arranging for the furnishing of, any item or service reimbursable under an FHCP. The statute's prohibition extends to remuneration to induce, or in return for, the purchasing, leasing, or ordering of, or arranging for, or recommending the purchasing, leasing, or ordering of, any good, facility, service, or item reimbursable by an FHCP. For purposes of the AKS, "remuneration" includes the transfer of anything of value, directly or indirectly, overtly or covertly, in cash or in kind.

Violation of the AKS constitutes a felony punishable by a maximum fine of $100,000, imprisonment of up to 10 years, or both. A conviction also will lead to exclusion from FHCPs. When a person commits an act described in the AKS, the U.S. Department of Health and Human Services, Office of the Inspector General (OIG) may initiate administrative proceedings to impose civil monetary penalties.[3] The OIG also may initiate administrative proceedings to exclude such person from FHCPs.[4]

So practically, how do earn-outs get raised in physician practice acquisitions? In most cases, if the buyer can't agree with the seller on valuation, it might look to offer a carrot to get the deal done. That carrot may be in the form of an earn-out that essentially says that if the seller meets some financial metric down the road, they will get paid additional purchase price. Here is a potential example:

> Dr. Smith is an orthopedic surgeon, and his practice accepts commercial, Medicare, Medicaid, and Tricare patients. Buyer is a large multi-state orthopedic group that has been in the marketplace looking to consolidate orthopedic physician practices. Dr. Smith and his advisors believe that his practice should be valued at $25 million. The buyer isn't convinced from its review of Dr. Smith's financials that the practice is worth nearly that much. In its letter of intent, the buyer offers Dr. Smith $17.5 million at closing and an additional $7.5 million within 18 months of the closing if the practice achieves 20% growth in earnings before interest, taxes, depreciation, and amortization (EBITDA) from its closing EBITDA (a defined number in the transaction documents).

The structure of the financial offer in the example above can have serious AKS risk. In this example, the purchase price structure provides additional purchase price to a seller in relation to the seller's business meeting a financial metric post-closing based in whole or in part on the practice's receipt of additional FHCP business. The payment for that additional FHCP business can fit the statutory AKS prohibition relating to the receipt of remuneration in exchange for the referral of FHCP business. Further, the risk is increased if the seller can directly influence the EBITDA growth (that includes FHCP dollars) by, for example, simply treating additional FHCP beneficiaries. Additionally, if the parties agree to this structure, the letter of intent and certainly the transaction documents can easily represent evidence of intent to enter into the business arrangement. Because the revenue growth includes FHCP business, an enforcement agency could argue that the buyer is paying the additional $7.5 million for Dr. Smith's activities in generating additional FHCP business.

Not all earn-outs, however, carry that same level of significant AKS risk. The earn-out structure is important to assess whether and how much AKS risk exists. Here is another example using the same hypothetical seller from the previous example:

> The buyer is concerned that Dr. Smith's practice had a significant slowdown in outpatient surgeries during the pandemic. It doesn't have a good way of predicting whether or not the practice's financial performance will return to its pre-pandemic levels. A $25 million valuation is based on the practice's pre-pandemic level of outpatient surgery performance. In its letter of intent, the buyer offers Dr. Smith $20 million at closing and an additional $5 million within 12 months of the closing if the practice returns to its pre-pandemic outpatient surgery performance without regard to any changes in the financial performance of the practice.

In this example, there is less risk of an AKS violation because the additional purchase price offer is structured to bridge a difference in valuation between the buyer and seller. Essentially, it is designed to validate the seller's pre-pandemic valuation. Here, the earn-out is not tied to specifically increasing the amount of FHCP business the practice receives post-closing but rather proving that the practice can perform at the historical levels that underly the seller's valuation. The intent of the parties is to address the difference in valuation and validate whether the business can perform as it did pre-pandemic. As a result, the nexus in the AKS prohibition between the referral of FHCP business and remuneration is not as clear, and it would be more difficult to substantiate an AKS violation.

The distinction between the two examples and the associated risk primarily involves whether the additional purchase price to be paid to the seller post-closing is for some amount of additional FHCP business that the seller generates versus validating the practice's historical value.

Conclusion

Given the effect the pandemic has had and continues to have on physician practice operations and transactions, determining the appropriate assets to value and valuation methodology is not always clear and straightforward. Parties to a potential transaction should utilize appropriate financial and valuation experts to ensure that, first and foremost, they can agree on the assets to be valued and related financial terms. Equally as important, the parties should incorporate any necessary fair market value considerations that may be required from a regulatory perspective. It may seem self-evident to the healthcare attorney readers of this article; however, parties to healthcare transactions often don't involve health regulatory counsel until after they have entered into certain preliminary agreements on price and valuation in a letter of intent or similar written arrangement. Selecting the wrong valuation premise and methodology and agreeing to an inappropriate earn-out structure in those early negotiations can carry its own serious regulatory risk.

As a perfect example, and discussed above, the AKS not only criminalizes the exchange of remuneration, but it specifically criminalizes the "offer" and "receipt." The AKS provides

"[w]hoever knowingly and willfully solicits or receives… and [w]hoever knowingly and willfully offers or pays… shall be guilty of a felony…"[5] In this respect, *Buyer and Seller Beware*, the entering into a letter of intent (LOI) with terms that seek to address valuation concerns but potentially create an AKS violation can get the parties into hot water. Additionally, it should be recognized that even if the parties develop a more compliant purchase price structure before they consummate a transaction, if that new structure is later called into question and evidence of an even less compliant structure exists from an earlier LOI, the ability of the government to establish its case with respect to the parties' intent becomes easier.

Ultimately, physician practice transactions are expected to proceed at breakneck speed where there will likely be valuation issues with important compliance implications. Parties to these transactions should utilize competent financial and valuation experts and health regulatory counsel to stay within regulatory compliance guardrails, particularly while the pandemic-related issues persist.

Ari J. Markenson, J.D., M.P.H., practices at the intersection of healthcare, law, and business. Ari advises clients, including investors, lenders, healthcare providers, and suppliers, on a broad range of regulatory and corporate matters, and has significant experience with complex acquisitions and financial transactions. He regularly advises clients on compliance and regulatory matters, including conditions for participation; fraud and abuse; and survey, certification, licensure, and enforcement issues. He can be reached at AJMarkenson@Venable.com.

Jerry M. Chang, CFA, is a senior managing director and partner with Ankura Consulting Group, where he leads the firm's Healthcare Valuation Advisory Services practice. Jerry has advised clients and legal counsel for over 25 years on issues related to transaction planning, regulatory compliance, tax compliance, financial reporting, restructuring, and expert witness testimony. Jerry has also served as valuation and transaction advisor to six state attorney general offices related to nonprofit conversion transactions. He can be reached at jerry.chang@ankura.com.

---

[1] Pratt SP, Reilly RF, Schweihs RP. *Valuing Small Businesses and Professional Practices*, 3rd Edition. New York City, New York: McGraw-Hill Education, 1998, 46-47.
[2] Federal health care programs defined in 42 U.S.C. §1320a–7b(f).
[3] *See*, 42 U.S. Code § 1320a–7a.
[4] *See*, 42 U.S. Code § 1320a–7.
[5] 42 U.S. Code § 1320a–7b(b)(1) and (2).