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Third Party Valuation No Silver Bullet in Health Care Deals:

Drakeford v. Tuomey and U.S. vs. Bradford Regional Medical Center

With the Affordable Care Act and market forces driving consolidation and creative transactions across the health care industry, health care professionals and deal makers have come to rely heavily on third party valuation reports to support compliance with the Stark Law, the federal Anti-Kickback Statute, the False Claims Act ("FCA") and other health care regulatory requirements. However, even a strong valuation report does not shift the burden of proof to regulators; at best serving only as one persuasive fact¹. A valuation report that fails to take into account the stringent requirements of the Stark Law, including appropriate use of valuation methodologies, offers even less comfort, as illustrated by *Drakeford v. Tuomey*, CA No. 3:05-2858-MBS (US District Court, SC, 9/13/13).

In the *Tuomey* case, which was affirmed in federal court just this fall, *Tuomey Healthcare System, Inc.*, a South Carolina hospital, entered into part-time employment agreements with 19 endoscopists paying them 131 percent of their net collected revenues in order to prevent them from moving from its ambulatory surgery center into lower cost competing locations. With compensation 31 percent in excess of collections from personally performed services and each service performed resulting in a facility fee payment to the hospital, this arrangement was found to violate the Stark Law's physician self-referral prohibition and the FCA.

At trial, the jury found that the compensation arrangement takes into account the volume and value of referrals for designated health services. Notably, *Tuomey* obtained a valuation opinion, but it was deeply flawed, as it approved as fair market value compensation both (i) 90 percent compensation and full benefits for part-time physicians and (ii) compensation 31 percent in excess of net collected revenues. The hospital now faces treble damages under the False Claims Act in excess of \$250 million.

In *U.S. vs. Bradford Regional Medical Center, et al.*, Civil Action No. 04-186 Erie (WD PA, Nov. 10, 2010), the court found that a hospital's payment to a cardiology group for a non-compete in connection with the group's sublease of a nuclear medicine camera to the hospital violated the Stark Law, notwithstanding a fixed fee arrangement supported by an independent fair market value opinion. The court reasoned that the appraisal method deployed by the third party valuator inappropriately took into account the volume or value of anticipated referrals from the cardiology group based on expected increased referrals in the interest of supporting the group's own cardiac imaging service. Specifically, the valuation was derived from projected future income that assumed the cardiology group would refer to the hospital because of the non-compete.

Some critical considerations based on *Tuomey*, *Bradford* and similar cautionary tales:

- Take little comfort in a valuation prepared without sufficient understanding or appreciation of the requirements of the Stark Law, the AKS, the FCA, and applicable health care regulations. Simply obtaining a fair market value opinion does not inoculate parties from liability, especially if the underlying transaction does not comply, and a valuation prepared using inappropriate methods can actually make matters worse.

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- Valuations should ideally blend multiple methods to balance the flaws of any one approach, incorporating the market and cost methods in addition to the commonly deployed income approach. While a dearth of comparable transactions may undermine use of the market approach and the cost approach may fail to fully value the “goodwill” of an enterprise, beware of the linkage that regulators may make between the income method and impermissible compensation for “volume or value of referrals.”
- Be sure your professionals work together as a fully integrated team. A valuation fundamentally depends on the accounting data and transaction details provided, which must be coupled with a strong command of the requirements of the Stark Law, the AKS, the FCA, and applicable health care regulations. Make sure that your professionals are communicating early and often in the process to obtain the most effective valuation for your transaction.

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[Michael King](#). Health care transactional matters, including structuring joint ventures and contractual arrangements, mergers and acquisitions, and financing transactions.

[Darryl Landahl](#). Health care regulatory and transactional matters, including structuring health care joint ventures and contractual arrangements, compliance program development and implementation, and medical staff and peer review issues.

¹ Notably, the Stark Law commentary states that “the definition of ‘fair market value’ in the statute and regulation is qualified in ways that do not necessarily comport with the usage of the term in standard valuation techniques and methodologies.” In contrast with IRS guidance around reliance on valuations, CMS declined to create a rebuttable presumption if the parties rely in good faith on a qualified independent valuation, asserting that “while good faith reliance on a proper valuation may be relevant to a party’s intent, it does not establish the ultimate issue of the accuracy of the valuation figure itself.” 69 Fed. Reg. 16107 (March 26, 2004).

This document is intended to provide you with general information regarding Third Party Valuation. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorney listed or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

[Michael W. King](#)
Shareholder
mking@bhfs.com
Denver
T 303.223.1130

[Darryl T. Landahl](#)
Shareholder
dlandahl@bhfs.com
Denver
T 303.223.1117