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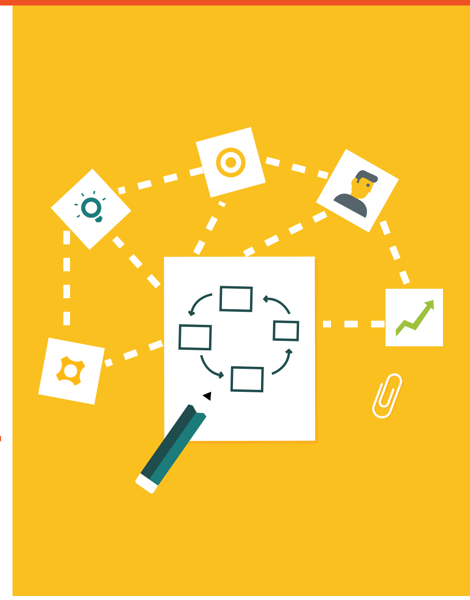
2017 Health Care Transactions Resource Guide



Fairness Opinions and Fair Market Value Opinions in the Health Care Provider Setting

Todd Kaltman, Managing Director, Duff & Phelps
todd.kaltman@duffandphelps.com

Dan Platten, Director, Duff & Phelps
Daniel.platten@duffandphelps.com

Price, terms, and value are key considerations when entering into transactions such as mergers, acquisitions, divestitures, and joint venture formations. Given the litigious and regulatory-driven nature of the business environment, particularly in the health care setting, it is critical that any management team and board of directors diligently analyze these aspects of a potential transaction, and that analysis may be greatly enhanced by the retention of independent financial advisors. Two advisor tools to consider as part of any transaction diligence are fairness opinions and fair market value (FMV) opinions. Based on the nature and size of a particular transaction, a company's counsel and board of directors should determine what appropriate measures are to be undertaken and ensure that they enlist the assistance, where appropriate, of qualified and experienced valuation and corporate finance advisors. The table below presents several of the key differences between fairness opinions and FMV opinions, followed by a more detailed discussion of both.

Fairness Opinions

A fairness opinion is a written opinion, most typically addressed to a board of directors, stating that specific aspects of a given transaction are fair—from a financial point of view— to a specific constituency of the company. In its most basic form, such as in the sale of a for-profit entity, a fairness opinion might state that the consideration to be received by the common shareholders of the company is fair to those shareholders from a financial point of view. From the other side of an acquisition, the opinion might state that the consideration to be paid by a company is fair to the company (i.e. the buyer) from a financial point of view. Thus, such opinions may sometimes address fairness to the company

Table 1: Differences Between Fairness Opinions and FMV Opinions

Fairness Opinion	Fair Market Value Opinion
Prepared for those with a fiduciary duty (e.g., Board of Directors, State AG)	Prepared for the buyer and/or seller
Actual buyer and seller	Hypothetical buyer and seller
No mandated Standard of Value–May vary depending upon transaction	Standard of Value defined by IRC 59-60 and further language within Stark Laws
Conclusion: Fair from a financial point of view	Conclusion: Estimated Fair Market Value range
Deliverable: Opinion letter and Board of Director presentation	Deliverable: Full valuation report (narrative and exhibits) to the engaging party or parties

rather than any particular group of stakeholders. This is especially prevalent in the health care context, where so many industry participants are not-for-profit entities and, accordingly, do not need to address the interests of individual shareholders. Instead, these board members have a duty to act as guardians of assets that many state attorneys general view as being in the public trust. In that regard, in many cases state attorneys general may insist that a fairness analysis be prepared and provided to regulators to review in connection with their approval of a transaction.

Board members have well-established fiduciary duties to the companies they oversee, including a duty of loyalty and a duty of care. When deciding whether to pursue a material corporate transaction, boards must ensure that proper care is taken in considering the myriad aspects surrounding that transaction, whether financial, regulatory, technological, or human-capital related. However, while every board member brings unique expertise to the table that should be relevant to the overall mission or strategy of any company, they are not expected to be an expert on every topic. Thus, it is reasonable for boards to seek outside advice on matters that do not fall within their area(s) of expertise. Indeed, to carry out their duty of care, it can be argued that many directors should enlist the assistance of expert advisors. Furthermore, state law generally provides that directors are entitled to rely in good faith on third-party experts if those experts have been selected with reasonable care.[1] So long as boards can show that they have fulfilled their primary duties of loyalty and care, courts will generally defer to their decisions (even if those decisions later prove to be wrong) under the business judgement rule. In that regard, fairness opinions are tools that can assist boards in their deliberations surrounding the pursuit and ultimate approval of material corporate transactions. Ultimately, the proper use of a qualified advisor and reliance on that advisor's fairness opinion can go a long way in demonstrating that the duty of care was fulfilled.

How should a fairness opinion provider be selected? The two most important considerations are qualifications and independence. Qualifications should include deep domain expertise, both in the industry at hand and in providing fairness opinions. With respect to industry experience, the need is especially obvious and especially true in health care, which is a unique animal among all U.S. industries. With respect to fairness opinion experience, while a fairness opinion may be largely based on valuation considerations, the provider must also be expert in analyzing all financial aspects of a given transaction, and the provider firm should have the infrastructure and procedures in place to ensure high-quality, unbiased analyses and conclusions, including peer review processes and a well-functioning committee approval process. In fact, the importance of an opinion approval committee was underscored in 2007 when the Financial Industry Regulatory Authority (FINRA, at the time, the National Association of Securities Dealers) adopted Rule 5150, which provides, in part, that any FINRA member providing a fairness opinion must disclose in the opinion whether or not the fairness opinion was approved or issued by a fairness committee,[2] and further that:

Any member issuing a fairness opinion must have written procedures for approval of a fairness opinion by the member, including:

1. The types of transactions and the circumstances in which the member will use a fairness committee to approve or issue a fairness opinion, and in those transactions in which it uses a fairness committee:

   A. The process for selecting personnel to be on the fairness committee;

   B. The necessary qualifications of persons serving on the fairness committee;

   C. The process to promote a balanced review by the fairness committee, which shall include the review and approval by persons who do not serve on the deal team to the transaction; and

2. The process to determine whether the valuation analyses used in the fairness opinion are appropriate.[3]

While the committee process within a provider firm will guard against bias on the part of individuals performing the fairness analysis, the firm itself should be selected by the board with a careful eye towards institutional independence. The most obvious independence issue arises when an advisor has a financial interest in the transaction itself. For instance, on the sell-side of a transaction in which an investment banker has been used, the simplest route for a board to take may be to request a fairness opinion from that banker. A valid argument can be made that after conducting a credible sale process, speaking to potential buyers, hearing their questions and concerns, and collecting bids, the investment banker on the deal may be in the best position to know the true market value of the subject company. However, if that banker stands to earn a large fee contingent on the successful closing of the deal, then at the very least someone on the outside looking in (i.e. stakeholders and courts) may readily argue that the banker is incentivized to say that the deal at hand is fair in order to close the transaction and collect the fee. While the opinion may be valid and the underlying analysis free of bias, the potential for someone to make this claim is a real issue that should be considered when selecting a fairness opinion provider. Other areas of independence to consider are existing and potential future relationships between the provider and the transaction parties and whether those relationships might influence the outcome of the analysis. This area of potential conflict is important enough that FINRA Rule 5150 requires significant disclosure within the opinion regarding compensation issues and prior or expected future relationships with any transaction parties. It should be noted that FINRA Rule 5150 only applies to opinions issued by FINRA member firms and only in instances where the member knows or has reason to know that the opinion will be provided or described to the recipient company's public shareholders. Nonetheless, in the author's opinion, best practices dictate that all reputable firms follow all provisions of the rule regardless of their membership status or who is expected to receive the opinion.

Of course, once a fairness opinion provider is selected, then the real work must begin. The essence of any fairness analysis consists of weighing the "gives" against the "gets." As noted, one typical form of opinion might address fairness to the buyer of the consideration to be paid by a company in an acquisition. In that case, the "give" consists of the consideration paid and the "get" consists of the assets/business acquired. If the deal consists of the acquisition of an entire company for cash consideration, then the analysis boils down to the value of the business acquired. The underlying valuation analysis will then generally comprise the methodologies discussed below regarding FMV opinions. However, it is easy to imagine the analysis quickly getting more complicated. The purchase price might include an earn-out that needs to be valued. Or consideration might be paid in the form of the buyer's stock, necessitating valuation of that stock. On the other side of the ledger, a transaction might not entail purchase of an entire business but rather, certain minority interests or preferred stock, or perhaps even contributions to a joint venture so that everyone's contributions need to be valued and weighed against the value of the joint venture interest received. In all of these instances, variations on basic valuation methodologies will underlie the analysis, but their application to the proper basket of assets or income streams by the advisor are critical.

While underlying analytical methods may be the same as those employed in any valuation analysis, it is important to note one key difference between a fairness analysis and a FMV opinion. The latter analysis is generally based on a hypothetical willing buyer and willing seller, whereas the former considers the specific deal at hand, including the specific transaction parties. One example of where this might come into play is in the buy-side fairness opinion where the buyer may be willing to pay more than others because of realistically envisioned synergies. In a fairness opinion context, it is not necessarily improper to include at least some portion of the value of those synergies in the analysis. Of course, in the context of health care transactions, any inclusion of synergies must be carefully scrutinized to ensure that the buyer is not paying for referrals (discussed below) or using its tax-exempt status to justify paying a higher price.

Financial advisors should be given adequate time to perform their task, which includes information gathering (both from the company and from public sources), management interviews, preparation of the appropriate analyses and documentation, internal peer reviews, and committee approval. None of this happens overnight, and a solid record of a thoughtful and deliberate process in which an advisor had appropriate lead time will go a long way towards demonstrating that the board fulfilled its duty of care.

That lead time should also include enough time to deliver work product to the board ahead of any meeting at which final transaction approval is sought. That work product will usually consist of two items. First, the opinion itself. The opinion will set out parameters of the fairness determination (i.e., fair to the common stockholders of the company from a financial point of view), describe the transaction at hand, lay out scope of analysis and engagement, and detail the various assumptions and limiting conditions. However, the opinion generally does not contain any detail regarding the underlying analysis leading to the conclusion of fairness. This information should be contained in a separate document. The financial advisors should provide a presentation for the board, and be prepared to walk the board through the materials as a guide to further discussion. The board presentation should contain a summary of the analysis, such as historical and projected financial information and financial and valuation data from comparable public companies and comparable transactions to the extent they are used in the analysis.

Finally, it is important to debunk some misconceptions and point out what a fairness opinion is not. The opinion will state that certain terms (i.e., consideration paid or received) are fair to a particular party or class of parties from a financial point of view. That means that the consideration paid or received falls within a reasonable range of value indicated by the advisor's analysis. It does not mean that the seller is receiving the highest price or the buyer is paying the lowest price. The opinion only indicates that the price is within (or better than) the range of values determined by the opinion provider. A fairness opinion is also not a recommendation to board members, shareholders, regulators, or anyone else that a transaction should be approved. There are many additional considerations beyond financial fairness that must guide the decision-making process, such as legal, regulatory, strategic, and corporate culture considerations, to name a few. A fairness opinion only addresses one narrow, albeit critically important, aspect of a transaction and is not a substitute for thorough diligence and debate by a board of directors in making the decision to engage in any corporate transaction.

Fair Market Value Opinions

Fair Market Value opinions provide an estimated value range in order to determine the purchase consideration for regulatory compliance purposes. While there are many similarities to fairness opinions in relation to the actual valuation analysis, differences exist, including the overall purpose and deliverables. Also, while fairness opinions are primarily driven by the duties and responsibilities of boards and management, FMV opinions are a function of the regulatory environment within the health care industry. Transactions not consistent with FMV are subject to significant penalties. In fiscal year 2016, the Federal Government won or negotiated over $2.5 billion in health care fraud judgments and settlements,[4] many related to issues with FMV. The following provides a summary of the regulatory framework.

Regulatory Framework

Fraud and abuse laws—namely the Physician Self-Referral Law (or more commonly referred to as "Stark Law") and the federal

Anti-Kickback Statute, as well as tax-exempt regulations—require that certain transactions and arrangements be in compliance or consistent with FMV. Otherwise, civil and criminal penalties may result.

Below presents the definition of FMV as well as relevant regulatory guidance that drives the importance of FMV. A comprehensive regulatory framework overview of federal fraud and abuse laws and tax-exempt laws are beyond the scope of this article. The information related to these laws is provided below as further context regarding FMV.

Fair Market Value is defined within Revenue Ruling 59-60 and Stark Law. Specifically, Revenue Ruling 59-60 states:

> "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."

Further modified by Stark Law (42 CFR §411.351):

> "General market value" means the price that an asset would bring as the 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…"

> "…acquisition, or the compensation that has been included in bona fide service agreements with comparable terms at the time of the agreement, where the price or compensation has not been determined in any manner that takes into account the volume or value of anticipated or actual referrals…"

Stark Law also incorporates the aspect of "commercially reasonable," specifically:

> "An arrangement will be considered 'commercially reasonable' in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician of similar scope and specialty, even if there were no potential DHS [designated health services] referrals."[5]

Tax-exempt regulations (U.S.C. Section 501(c)(3)) states the following:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

The Anti-Kickback Statute[6]

The federal Anti-Kickback Statute (Anti-Kickback Statute) is a criminal statute that prohibits the exchange (or offer to exchange), of anything of value, in an effort to induce (or reward) the referral of federal health care program business. See 42 U.S.C. § 1320a-7b. The Anti-Kickback Statute is broadly drafted and establishes penalties for individuals and entities on both sides of the prohibited transaction. Conviction for a single violation under the Anti-Kickback Statute may result in a fine of up to $25,000 and imprisonment for up to five (5) years. See 42 U.S.C. § 1320a-7b(b). In addition, conviction results in mandatory exclusion from participation in federal health care programs. 42 U.S.C. § 1320a-7(a). Absent a conviction, individuals who violate the Anti-Kickback Statute may still face exclusion from federal health care programs at the discretion of the Secretary of Health and Human Services. 42 U.S.C. § 1320a-7(b). The government may also assess civil money penalties, which could result in treble damages plus $50,000 for each violation of the Anti-Kickback Statute. 42 U.S.C § 1320a-7a(a)(7). Although the Anti-Kickback Statute does not afford a private right of action, the False Claims Act provides a vehicle whereby individuals may bring qui tam actions alleging violations of the Anti-Kickback Statute. See 31 U.S.C. §§ 3729–3733. When a private citizen sues on behalf of the Federal government and is successful, they receive a percentage of the ultimate recovery for their "whistleblower" efforts. See id.

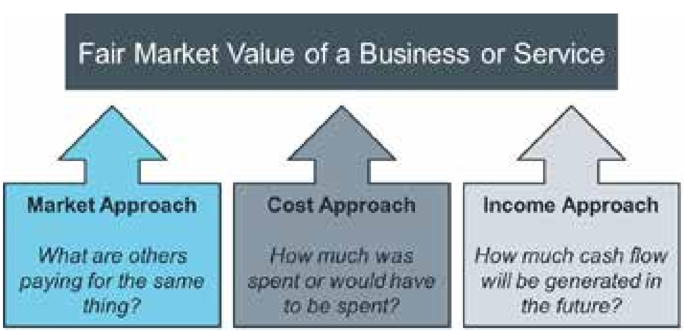
In recognition of the broad range of transactions potentially implicated by the Anti-Kickback Statute, certain types of payments are excluded from consideration by statute. 42 U.S.C. § 1320a-7b(b)(3). In addition, the U.S. Department of Health & Human Services (HHS) Office of Inspector General (OIG) has been given authority to adopt "safe harbors" to protect specifically identified business and financial practices from criminal and civil prosecution, provided they fall within parameters defined to minimize the risk for potential corruption. See 42 C.F.R. § 1001.952. Transactions not specifically excluded or granted safe harbor protection are not per se violations of the Anti-Kickback Statute but are evaluated by the OIG on a case-by-case basis. See Office of Public Affairs, Office of Inspector General Department of Health & Human Services, Fact Sheet November 1999, Federal Anti-Kickback

Table 2: Key Considerations—FMV for Health Care Regulatory Compliance

Regulatory guidance	Specific legal aspects driven by Stark Laws, Anti-Kickback Statue, and tax-exempt regulations.
Projections used in Income Approach	Important to be cognizant of certain synergies included in projections used in the Income Approach such that they are consistent with the regulatory framework.
Normalized base year	May need to include normalizing adjustments to historical financial statements to reflect a hypothetical buyer and/or seller.
Post-transaction compensation	In transactions where the target's owner is a physician or physician group to be employed, post-transaction compensation must be carefully considered and included as part of the valuation analysis.
Capital expenditures and needs assessment	If a business projects future growth, is the existing plant, property and equipment sufficient to support that growth? What is the economic life of existing and new equipment?
Income taxes	A hypothetical buyer could be either a not-for-profit or for-profit entity; a not-for-profit cannot use its tax-exempt status to justify a higher purchase price, and a for-profit entity cannot offer a higher purchase price to a not-for-profit entity—penalties exist.
Economic obsolescence	Divergence among practice as to whether intangible and goodwill value may exist absent sufficient cash flow. The selected approach must be thoroughly examined and documented based on the facts and circumstances of a transaction.
Licenses or Certifications	Do existing licenses provide a competitive advantage? If there are forecasted expansions, are new licenses required?
Deliverables	Prepared for the parties of the transaction. See below for additional details.

Laws and Regulatory Safe Harbors. Parties who are uncertain whether their arrangements qualify for exclusion or safe harbor protection may request an advisory opinion from the OIG. See id.

Table 3: Approaches to Estimate Value: Income, Market, and Cost



While much of the valuation analysis is similar to that of a fairness opinion, there are critical nuances to know and understand when undertaking the FMV analysis for health care regulatory compliance purposes. A significant contrast with fairness opinions is that the FMV estimate requires the analysis based on a hypothetical buyer and hypothetical seller, rather than an actual buyer and seller within a fairness opinion. This drives many assumptions in the analysis, including but not limited to the type and level of synergies assumed in the Income Approach. Key considerations are summarized in Table 2, presented above.

Deliverables

Ultimately, the FMV analysis comprises full valuation report and supporting schedules. It is critical to provide sufficient detail regarding all inputs and assumptions used in the analysis so that any third party has the ability to understand the analysis and conclusions on a stand-alone basis. Statement on Standards for Valuation Services No. 1[7] (SSVS 1) describes the types of valuation reports a valuation analyst may use to communicate the results of an engagement to estimate value. SSVS No. 1 applies to all AICPA members who perform valuation services for various purposes (such as transactions, financings, taxation, financial accounting, bankruptcy, management and financial planning, and litigation) as well as for various disciplines in the profession (including consulting, litigation services, personal financial planning, tax, and accounting). Other professional organizations maintain similar requirements (e.g., The Appraisal Foundation mandates the Uniform Standards of Professional Appraisal Practice). Per SSVS 1, a detailed report should include, as applicable, the following sections:

- Letter of transmittal
- Table of contents
- Introduction
- Sources of information
- Analysis of the subject entity and related nonfinancial information
- Financial statement/information analysis
- Valuation approaches and methods considered
- Valuation approaches and methods used
- Valuation adjustments
- Nonoperating assets, nonoperating liabilities, and excess or deficient operating assets (if any)
- Representation of the valuation analyst
- Reconciliation of estimates and conclusion of value
- Qualifications of the valuation analyst
- Appendices and exhibits

SSVS 1 further details each section and information that one should consider including in the report. The level of detail to include in each section is dependent on the type of valuation engagement (e.g., litigation, financial reporting, health care regulatory compliance, etc.). For valuation engagements under health care regulatory compliance, commentary regarding the regulatory framework should also be considered.

The valuation report is restricted to the intended user(s), except if noted otherwise within the report or in the assumptions and limiting conditions. A rigorous and robust valuation process should be put in place to ensure the intended users have a high quality and comprehensive report. Further, the report may be subject to additional scrutiny should it be challenged or brought into litigation. Similar to the fairness opinion process previously discussed, an appropriate FMV analysis includes an independent team and various levels of review. While working as a team and collaborating throughout the analysis, the deliverables should be reviewed internally at various steps. At Duff & Phelps for example, analyst/senior associate work is further reviewed by a vice president/director, then by the managing director and lastly, a concurring review by a second managing director. Finally, the process requires the appropriate quality controls of all deliverables, including an independent calculation check and tie-out by a staff person not involved with the day-to-day engagement.

Conclusion

Successful health care transactions face significant challenges from regulatory, operational, and financial risks. Fairness opinions and fair market value opinions provide two tools to mitigate further risk. As discussed in this article, there are many aspects to consider when engaging a party to provide a particular opinion and/or report. Stakeholders in a transaction are best served when they discuss these issues upfront and consider the retention of experienced and independent financial advisors. ◆

Endnotes

1 As a primary example, see Delaware General Corporation Law §141(e), which states: "A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation."

2 FINRA Rule 5150(a)(5) – see http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6832.

3 Ibid - FINRA Rule 5150(b).

4 The Department of Health and Human Services And The Department of Justice Health Care Fraud and Abuse Control Program Annual Report for Fiscal Year 2016 (January 2017).

5 42 CFR Parts 411 and 424. "Medicare Program; Physicians' Referrals to Health Care Entities With Which They Have Financial Relationships (Phase II)."

6 The American Health Lawyers Association, Health Law Glossary.

7 *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*; Issued by the AICPA Consulting Services Executive Committee (June 2007).