Traversing the Threshold of Commercial Reasonableness
In the Healthcare Industry

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In response to the advent of emerging accountable care and value-based reimbursement models, which rely on achieving better outcomes at lower cost, hospitals are increasingly seeking closer relationships with physicians, including direct employment, contracting, co-management, and joint ventures.[1] Corresponding with this growing trend toward hospital-physician alignment, there has been increased federal, state, and local regulatory oversight regarding the legal permissibility of these arrangements. There has been more intense regulatory scrutiny related to the *Anti-Kickback Statute* (AKS) and the *Stark Law*, especially as they relate to potential liability under the *False Claims Act* (FCA).[2] Notably, in fiscal year (FY) 2013, the *U.S. Department of Justice* (DOJ) opened 1,013 new criminal healthcare fraud investigations and 1,083 new civil healthcare fraud investigations, a substantial increase from the 878 criminal healthcare fraud investigations and 776 civil healthcare fraud investigations opened in FY 2007.[3]

Fraud and abuse laws scrutinize many aspects of healthcare transactions, including physician compensation arrangements, under both the valuation standard of *fair market value* (FMV) and the separate, but related, threshold of *commercial reasonableness* (CR).[4] It is critical to obtain and maintain appropriate documentation that each physician compensation arrangement (whether it be for clinical services, administrative services, on-call services, or a combination of services) meets both the standard of FMV and the threshold of CR in order to withstand regulatory scrutiny. Typically, legal counsel does not provide opinions as to the CR of a compensation arrangement,[5] and will most often retain and rely upon an independent valuation consultant to provide a certified valuation opinion that the arrangement does not exceed FMV and meets the requirements of CR. Due to the increase in healthcare transactions, notably from the first to second quarter of 2014,[6] opinions related to the CR of healthcare transactions are becoming an "*increasingly important service offered by healthcare valuation professionals*."[7]

Rendering a CR opinion requires that a specific set of *core competencies* be mastered by the valuation analyst *apart from*, but *related to*, the more traditional *knowledge*, *skill set*, and *experience* required in rendering FMV opinions related to the appraisal of the *enterprises*, *assets*, and/or *services* being transacted. The key components of a CR analysis include both a consideration of the *qualitative* factors that affect the CR opinion, as well as a *quantitative* analysis of the elements of the anticipated transaction of the subject enterprise, asset or service.[8]

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This white paper will first address the definitions of CR and illuminate the subtle differences of CR definitions among federal regulatory bodies in order to provide indications as to the manner of assessing the factors and elements within the CR analysis.

Definition of Commercial Reasonableness

While definitions of the *commercial reasonableness* threshold are similar among the various federal agencies tasked with enforcing regulations affecting the healthcare industry, there are nuances between each agency's interpretation of the term "*commercial reasonableness*." The *U.S. Department of Health and Human Services* (HHS) has interpreted the term "*commercially reasonable*" to mean an arrangement which appears to be "*…a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals*."[9] Additionally, HHS's *Stark II, Phase II* commentary suggests that:

> "*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.*"[10]

The *Internal Revenue Service* (IRS) and OIG have also provided guidance in defining CR. IRS guidance regarding CR may be derived from IRS pronouncements on *reasonable compensation*, including:

(1) The 1993 Exempt Organizations IRS text titled "*Reasonable Compensation*," which states that "*reasonable compensation is…the amount that would ordinarily be paid for like services by like organizations in like circumstances;*"[11]
(2) Chapter 2 of Publication 535, titled "*Business Expenses*," which states "*…reasonable pay is the amount that a similar business would pay for the same or similar services;*"[12] and,
(3) Federal Regulations on "*Excess Benefit Transactions*," which state, "*reasonable compensation [is]…the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances*."[13]

It should be noted that no IRS pronouncement defining *reasonable compensation* specifically addresses the healthcare industry. However, these factors provide indications as to the manner of assessing CR thresholds in an anticipated healthcare transaction.

Additionally, in Title 42, Section 1001 in the *Code of Federal Regulations* (CFR), commonly referred to as the *Anti-Kickback (AKS) exceptions*, the OIG has defined a *commercially reasonable* transaction as one in which "*…the aggregate services contracted do not exceed those which are reasonably necessary to accomplish the commercially reasonable business purpose of the service*."[14]

Further guidance indicating that, beyond the *individual transaction elements*, the *entirety* of a *subject transaction* should be reviewed in the *aggregate* (inclusive of *all elements* for which consideration is given) is found in the *Personal Services* exception of the *Stark Law*. This exception requires that "*[t]he aggregate services contracted for do not exceed those that are reasonable and necessary for the legitimate business purposes of the arrangement(s).*"[15]

For transactions involving *aggregate* services, all elements of the integrated transaction must be accounted for in a CR opinion. Commonly referred to as a "*wrap around*" CR opinion, this type of analysis includes and considers *all elements* of the integration transaction in the *aggregate*, subsequent to the determination that each discrete, individual element of the transaction does not exceed FMV and meets the CR threshold. With complex acquisitions involving multiple property interests, a "*wrap around*" CR analysis provides a foundation upon which to establish and defend that the healthcare transaction is legally permissible and will withstand government scrutiny.

Relationship of the Threshold of Commercial Reasonableness to the Standard of FMV

While the analysis of the threshold of CR is separate and distinct from the development of a FMV analysis, requiring consideration of different aspects of the property interest included in the transaction, they are *related* thresholds, and the consideration and analysis of one threshold does *not* preclude the analysis of the other threshold. For example, a necessary condition for an anticipated transaction to be *commercially reasonable* is that each element of that transaction must not exceed FMV. However, even in the event that each element of an anticipated transaction does not exceed FMV, the anticipated transaction may still *not* be *commercially reasonable*, in that it does not meet the remaining analytical hurdles of a CR analysis. Consequently, a finding that an enterprise, asset, or service meets the FMV threshold is not, in and of itself, *sufficient* to establish CR.[16]

A further distinction between a CR analysis and the development of a FMV opinion is that the CR thresholds include consideration of the "*…value to the entity paying for…*"[17] the enterprise, assets or services being transacted, while the FMV opinion requires that a *universe of hypothetical buyers, sellers, owners* and *investors* be considered. For example, consider the acquisition of ten linear accelerators by a purchaser. If the purchaser has need of only one linear accelerator, the purchase of ten linear accelerators even at a FMV price would not meet the *necessity of the assets purchased* threshold of the CR analysis.[18]

Mastering the foundational principles for a CR analysis – including accurately understanding the definitions of CR, as well as the differences between an FMV opinion and a CR analysis – is essential before an analyst undertakes a CR analysis on behalf of a client. In an era of increasing regulatory scrutiny and growing healthcare transaction volume, accurately grasping the nuances of CR definitions can improve the analyst's understanding of the scope and objectives of a certified CR opinion regarding a particular transaction. Further, properly applying these definitions within the *qualitative* and *quantitative* analyses can increase the defensibility of the opinion, thereby supporting the efforts of healthcare providers to establish a defensible position that their proposed transaction is in compliance.

Commercial Reasonableness Prerequisites

To assess the *commercial reasonableness* of a proposed transaction, the valuation analyst should begin with certain prerequisite elements, including:

(1) Whether each element of a prospective transaction does not exceed *fair market value*; and,
(2) That the prospective transaction is a sensible, prudent business arrangement even in the absence of referrals.[19]

Pursuant to the Stark Law, Congress has explicitly stated that the requirement that the transaction be a sensible, prudent business arrangement in the absence of referrals applies to several elements of physician-hospital transaction, including the following:

(1) "*Rental of office space*;
(2) *Rental of equipment*;
(3) *Bona fide employment relationships*;
(4) *Personal service arrangements*;
(5) *Physician incentive plans*;
(6) *Physician recruitment*;
(7) *Isolated transactions, such as a one-time sale of property*; and,
(8) *Certain group practice arrangements*."[20]

The OIG for HHS, in its interpretation of whether a prospective transaction considered the volume or value of referrals, looks for any financial arrangement which may induce a physician to change their referral pattern, such as:

(1) "*…[A]rrangements [to] promote overutilization and…unnecessarily lengthy stays*;"[21] and,
(2) "*…[P]ayments to induce physicians…to reduce or limit services to…patients*."[22]

Therefore, transactions that take into consideration "*the value or volume of referrals*" will not meet the regulatory threshold of a CR analysis.[23]

After ensuring that each element of the prospective transaction does not exceed *fair market value*; and, that the transaction would be a sensible, prudent business arrangement, even in the absence of referrals, further analysis of both the *qualitative* and *quantitative* aspects of the proposed transaction is warranted to determine its *commercial reasonableness*.

Qualitative Analysis

The steps involved in the *qualitative* assessment of CR focus on determining the acquirer's business purpose(s), and how the anticipated transaction assists in meeting that purpose. The specific *qualitative* thresholds are as follows:

(1) Is the integration transaction necessary to accomplish the business purpose of the client;
(2) Does the nature and scope of the underlying elements of the integration transaction meet the business needs of the client;
(3) Does the enterprise and organizational elements of the integration transaction make business sense to the client;
(4) Does the quality, comparability, and availability of the underlying elements of the integration transaction make business sense for the client;
(5) Are there sufficient ongoing assessments, management controls, and other compliance measures in place related to the underlying elements of the integration transaction; and,
(6) Is the transaction otherwise legally permissible?[24]

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Business Purpose

In determining whether the transaction fulfills a "*…business purpose…*"[25] for the acquirer, the OIG and the IRS have provided definitional guidance, as follows:

(1) HHS commentary on the AKS regulations considers transactions to have a *business purpose* if they can be "*reasonably calculated to further the business of the lessee or acquirer*;"[26] and,
(2) The IRS defines *business activities* as those "*…carried on for the production of income from the sale of goods or the performance of services*."[27]

One element that may indicate a *sensible, prudent business arrangement* is the *anticipated economic benefit* to be derived from the *financial profitability* resulting from the transaction. It should be noted that economic benefit can be derived from both *monetary* and *non-monetary* sources; however the ultimate source of value is the *expected utility* to be derived from the ownership of a property interest. Financial remuneration (i.e., cash), in fact, is an intermediary economic benefit, whose value emanates from its exchange for an asset which directly provides utility. Utility from a transaction may arise from economic benefits other than short-term profitability, including:

(1) Expansion into new geographic areas;[28]
(2) Expansion into new business lines;[29]
(3) Augmenting existing service lines;[30]
(4) Diversification benefits;[31]
(5) Avoiding costs of establishing offices and facilities, management, and other resources, in place;[32]
(6) Operating expense reductions;[33]
(7) Increased asset utilization;[34]
(8) Reduced cost of capital and greater access to capital;[35]
(9) Horizontal integration;[36]
(10) Vertical integration;[37]
(11) Management and care protocols;[38]
(12) Increased access to technology and innovation;[39]
(13) Improved research & development;[40] and,
(14) Tax motivation.[41]

While these synergistic gains to a specific owner or investor, which would likely not be considered when performing a *fair market value* analysis, they may be a significant factor in establishing that a transaction is *commercially reasonable*.[42]

For a tax exempt 501(c)(3) organization, which must be *"…organized and operated exclusively for an exempt purpose…"*[43] such as, "*charitable, religious, educational, scientific,… [or] public safety…,"*[44] financial losses may be incurred to adhere to Revenue Ruling 69-545, as it relates to healthcare enterprises, which states, *"In the general law of charity, the promotion of health is considered to be a charitable purpose. […] A nonprofit organization whose purpose and activity are providing hospital care is promoting health and may, therefore, qualify as organized and operated in furtherance of a charitable purpose."*[45] This *charitable mission* provides the basis for the healthcare enterprises tax-exempt status, whereby presumably, in lieu of a *cash return benefit*, the tax-exempt organization will, in the service of their stated charitable mission, generate a *social benefit* for the community it serves. This *social benefit* may take the form of *indigent care* provided to the community in which the non-profit organization operates (note that, some for-profit healthcare organizations do provide indigent care but their incentive to provide this care may be different from that of charitable, non-profit organizations, which by mandate must provide the care), which may provide improved public health, a benefit that accrues to all members of the community. A further example of *social benefit* is the evolving mission and objective of tax-exempt hospitals, which has grown to include their role as *organizers* and *integrators* of care in a community, whereby they provide a *continuum of care* across a population, which may not necessarily be profitable, but are nonetheless necessary for the *health of the population* in that community.

Necessity of the Subject Property Interest

In assessing the *necessity of the subject property interest* to the purchaser, the OIG suggests that an analysis be performed as to whether "*…the items and services obtained… [are] necessary to achieve a legitimate business purpose of the [employer] (apart from obtaining referrals)*."[46] In addition, guidance related to the CR threshold of necessity may be gleaned from IRS pronouncements and regulations used in determining whether an item is considered a "*reasonable business expense*." For example, the IRS requires a determination of whether the property interest is "*necessary*"[47] for the business purpose of the purchaser, i.e., "*helpful and appropriate for the trade or business*,"[48] in light of the "*the volume of business handled*"[49] the number of "*beds, admissions, or outpatient visits*;"[50] "*the complexities of the business*;"[51] and/or, the "*size of the organization*."[52]

Further guidance from the HHS commentary on the AKS suggests that analysts should determine how the "*space, equipment, or services*" meet the "*…lessee or purchaser needs, intents to utilize, and…commercially reasonable business objectives*."[53] To determine the necessity of the subject property interest to the acquirer, a valuation analyst may consider the following:

(1) The prevalence and incidence of disease;
(2) The relative frequency of demographic and behavioral risk factors associated with diseases in the market service area, associated state(s), and the United States;
(3) The population trends of the market service area, associated state(s), and the United States;
(4) Current treatment options for the injury, ailment, or disease treated by the subject provider(s);
(5) The supply of physicians and other providers in the market service area, associated state(s), and the United States;
(6) The level of competition related to the subject property interest within the market service area;
(7) The economic costs related to disease in the market service area, associated state(s), and the United States; and,
(8) The payor environment in the market service area, associated states(s), and the United States.

Nature & Scope of Property Interest

Additionally, a CR opinion should include a determination as to whether the *nature and scope of the property interest* meet the business *needs* of the acquirer. Guidance regarding the *nature* and *scope* threshold of the CR analysis may, similarly to the *necessity* threshold, be gleaned from IRS pronouncements and regulations used to determine whether an item is a reasonable business expense. For example, the IRS has advised that the nature and scope of services provided should be analyzed to determine as to whether their cost is:

(1) A "*cost of carrying on a trade or business*;"[54]
(2) Undertaken "*for the production of income from the sale of goods or the performance of services*;"[55]
(3) "*…[P]aid or incurred during the taxable year*;"[56]
(4) "*…[R]easonable in terms of the responsibilities and activities…assumed under the contract*;"[57] and,
(5) "*…[R]easonable in relation to the total services received*."[58]

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Enterprise and Organizational Elements

Next, a CR opinion should include an analysis of the anticipated transaction in light of various *enterprise* and *organizational elements* of the acquirer. The IRS pronouncements regarding *reasonable compensation* for tax purposes indicate that a determination should be made as to whether the *consideration paid* for the property interest is "*…a sensible, prudent business agreement…*"[59] for the acquirer. This determination is made within the context of:

(1) "*[T]he pay compared with the gross and net income of the business;*"[60]

(2) The "*business policy regarding pay for all employees*;"[61]

(3) "*[T]he cost of living in the locality*,"[62] based on an analysis of the "*national and local economic conditions*"[63] including whether the acquirer is located in a "*…rural, urban, or suburban*"[64] area; and,

(4) The structure, size, and location of the purchaser.[65]

The anticipated transaction may require healthcare entities purchasing physician services to compensate those physicians at *a higher rate per unit of productivity* (e.g., per wRVU) than the physician *historically* earned in their private practice for providing the same services. Note that, a physician's compensation per unit of productivity in private practice may be lower than market survey data derived measures of *Fair Market Value* for several reasons, including:

(1) According to the theory of *utility maximization*, physicians would only pursue compensation levels above the amount they were able to generate from their own practice in *maximizing* their *individual compensation*, *wealth*, or *other measure of utility*. Further, those physicians receiving compensation for their services above the market survey derived measures of *Fair Market Value* would not be acting in their own *rational economic self-interest* by pursuing a transaction where they would be *paid less* for their services than what they are able to generate from their private practice;

(2) Under the economic *principle of* substitution, a potential *purchaser* of healthcare services would be *willing to pay up to the price* of a *desirable substitute*, and normative industry benchmark survey data can be utilized to determine the *most probable price* that the purchaser would *likely* expend for *substitute services*;

(3) The *historical level of return* on the subject services is strictly reflective of the outcome of the economic factors impacting the *operational performance* and *financial condition* of the use of that property interest in the physician's *prior practice*, which may not be reflective of the market as a whole;

(4) Purchasers or lessees of physician services, *bound* by *Fair Market Value* as a *ceiling price*, act to maximize their profit by acquiring at the *lowest total cost*, while sellers, *bound* by the *floor* set by the level of income they generated for their services from their prior physician practice, act to maximize their profit by selling the subject property interest at the *highest total price*. The point where both parties will choose to transact would fall between the *ceiling* set forth by the regulatory restriction of *Fair Market Value* and the *floor* set forth by the historical earnings of the physician from their prior practice. The degree by which the final negotiated price is closer to the *point of utility maximization* for the *buyer*, (i.e., the lowest total cost) or to that of the *seller*, (i.e., the highest total price) is determined, in great part, by the trade-off between *leverage* and *negotiating skill* between the two parties;

(5) In addition to maximizing their financial benefits, physicians may derive utility from *intrinsic* sources, such as the personal autonomy afforded to a physician owner of a practice, in contrast to an employed physician; and,

(6) The equivalency of knowledge between buyers and sellers may not be fully reflected in the bargain, as physicians, more typically highly trained in clinical subjects than in financial economics, may utilize and rely more heavily on *their past personal experiences*, which are not necessarily reflective of *future economic market realities*, in decision making.

As discussed above, tax exempt organizations must be organized and operated for an exempt purpose, and therefore, a CR analysis should consider whether the proposed transaction meets the exempt organization's *charitable mission*.

Quality, Comparability, & Availability

Another qualitative element of a CR analysis is whether the *quality*, *comparability*, and *availability* of the services, assets, and enterprises included in the anticipated transaction fit into the business purpose of the acquirer. The IRS pronouncements on *reasonable compensation* for tax purposes suggest that a CR analysis consider "*the ability and achievements of the individual performing the service*,"[66] including "*education*;"[67] "*specialized training and experience of the*" individual;[68] "*the history of pay for the employee*;"[69] and, "*…the availability of similar services in the geographic area*."[70] Additionally, the OIG advises that a CR analysis consider "*…the skill level and experience reasonably necessary to perform the contracted services,*"[71] especially if "*…the services [could be obtained] from a non-referral source at a cheaper rate or under more favorable terms*."[72] Finally, the Code of Federal Regulations specifies that when conducting an assessment as to the CR of a prospective transaction, valuation analysts should consider "*the type, expected life, condition…and market conditions in the area…[for] facilities or equipment…*,"[73] as well as whether "*adequate alternative facilities or equipment that would serve the purpose are not or were not available at lower costs*."[74]

Other elements of the transaction which may not fit neatly into the above discussed categories include:

(1) The "*…quality of management and interdisciplinary coordination*."[75] The government's expert witness report in the *U.S. v. SCCI Hospital Houston Central* case suggested that healthcare entities should conduct "*a regular assessment of the actual duties performed by the [employee]...[and] it should be clear how effective the [employee] is doing his assigned job and if there is a bona fide need for continuing the services*."[76]

(2) In the *U.S. v. Carlisle HMA, Inc.*, case, the Court ruled that healthcare entities need to determine whether the current "*consideration given and received [is paid] under materially different circumstances*"[77] than when the contract was entered.

(3) The OIG advises consultants to review transactions to determine if:
   - (a) "*the arrangements flow from an open, competitive request for proposal process…*;"[78]
   - (b) "*the risk that the arrangements will result in an appropriate utilization…*;"[79]
   - (c) "*the arrangements are…likely to have a negative effect on patient care*;"[80] and,

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(d) "*the arrangements…have an adverse impact on competition*."[81]

(4) A determination as to whether compensation for professional physician services does not exceed the level of collections for those services. In its appellate brief for the U.S. ex rel. Drakeford v. Tuomey case, the Department of Justice (DOJ) stated:

> "*Obert-Hong dealt with physician compensation arrangements where – unlike the Tuomey arrangements – the physicians did not earn more than their personal collections, and where there was no other basis to presume that the physicians were being paid for actual or anticipated referrals*." [82]

Within this statement, the DOJ implied that physician compensation arrangements where physicians are compensated for their professional services in excess of the collections generated by those services, might be considered by the government to be payment for *actual* or *anticipated referrals*, which would violate both the standard of *fair market value* and the threshold of CR. Further, the government's expert in the Tuomey case concluded that the physician contracts in question were "*commercially unreasonable*" since: "*… among other things,* [the physician contracts] *did not protect the financial interest of the hospital*,"[83] finding specifically that:

(1) "*The term of the physician employment agreements is ten years without provisions to change the physicians' compensation methodology*;
(2) *The physicians'' net outpatient collections are not required to exceed their practice overhead and their base salary before bonuses were earned*;
(3) *Combined with the cost of billing fees, each physician's compensation and benefits paid materially exceeded his or her Tuomey outpatient collections; and,*
(4) *Since their inception, Tuomey's physician practices have incurred material financial losses.*"[84]

Not Otherwise Legally Permissible

Even in the event that a transaction meets all of the foregoing qualitative elements, the transaction may not be considered *commercially reasonable* if it is *not otherwise legally permissible*. For example, factors to consider when assessing the *legal permissibility* of the anticipated transaction may be found in antitrust pronouncements by the Federal Trade Commission (FTC), which advise:

(1) The anticipated transaction "*…is likely to produce significant efficiencies…*";[85]
(2) "*These efficiencies include the provision of services at a lower cost or the provision of services that would not have been provided absent…*"[86] the anticipated transaction;
(3) The efficiencies achieved as a result of the anticipated transaction "*…will benefit consumers*";[87]
(4) The anticipated transaction will help "*…monitor and control costs…while assuring quality of care;*"[88]
(5) The anticipated transaction "*…appears likely, on the balance, to be procompetitive or competitively neutral;*"[89] and,
(6) The anticipated transaction "*…would not increase the likelihood of the exercise of market power…because of the existence of the post-[transaction] of strong competitors…*"[90]

Other legal edicts that significantly influence healthcare transactions include:

(1) The Stark Law;[91]
(2) The AKS; [92] and,
(3) The Internal Revenue Code.[93]

Of note is that, while valuation analysts must be versed in the rules and regulations surrounding the industry in which they provide services, typically, they do not offer or provide legal opinions. Thus, many CR opinions include a provision that states legal counsel has reviewed the arrangement and considers the proposed transaction to be legally permissible.

Standing alone, a transaction that overcomes the hurdles associated with the qualitative analysis is not yet deemed to be *commercially reasonable*; the analyst must then perform a *quantitative analysis* as part of its determination of CR.

Quantitative Analysis

Rendering a CR opinion requires that a specific set of *core competencies* be mastered by the valuation analyst *apart from*, but *related to*, the more traditional *knowledge base*, *skill set*, and *experience* required in rendering *Fair Market Value* (FMV) opinions related to the appraisal of the *enterprises, assets*, and/or *services* being transacted.[94] For example, when opining as to the FMV of an *individual discrete subject property interest*, a valuation analyst may use an *income approach*, which generally involves the following steps:[95]

(1) *Projecting the future net economic benefit* accruing to the owner of the subject property interest;
(2) *Determining the risk adjusted required rate of return* associated with the projected future net economic benefit arising from ownership or control of the subject property interest;
(3) *Discounting* the projected future net economic benefit related to the subject property interest back to the valuation date; and,
(4) *Summing all discounted future net economic benefit* related to the subject property interest to determine a value as of the valuation date.

The *post-transaction financial feasibility analysis* used in assessing the *quantitative* factors of an anticipated transaction is similar to the *income approach* in that it considers *projected future net economic benefit streams,* and an assessment of the *risk* related to the probability of realizing those benefits streams. However, a CR analysis differs from a FMV opinion in that it considers:

(1) *"All consideration to be paid by purchasers and lessees to sellers and lessors,"*[96] in the *aggregate*, when *projecting future net economic benefit*, not just the net economic benefits arising from the *individual discrete* subject property interests comprising the anticipated transaction;
(2) The *aggregate projected net economic benefits* of ownership or control accruing to a *particular buyer*, which may include any *"unique synergies the … particular buyer would realize as a result of acquiring the asset,"*[97] not the aggregate *projected net economic benefits* accruing to the *universe* of typical buyers, sellers, owners, and investors; and,
(3) An *economic cost/benefit analysis* (e.g., *payback period, net present value*, and *internal rate of return*) to determine whether the anticipated transaction makes *"commercial sense"* for a *particular buyer*, not just a single estimate or range of *monetary values* for the *universe* of buyers, sellers, owners, and investors.[98]

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The distinctions between a CR analysis and a FMV opinion discussed above, may lead to different underlying assumption being utilized in a CR analysis, including the following:

(1) *Projecting future net economic benefits* inclusive of the factors available to a *particular buyer* that may *not be available* under the FMV assumption of a *universe* of buyers, sellers, owners, and investors, e.g.:
   (a) *Revenue synergies*, e.g., increases in reimbursement yield which may result from a hospital *converting a free-standing physician practice*, which bills *Ancillary Service and Technical Component* (ASTC) services to Medicare under the *Medicare Physician Fee Schedule* (MPFS) on a non-facility basis using *Current Procedural Terminology* (CPT) codes, to a *Hospital Outpatient Department* (HOPD), which bills ASTC services to Medicare under the *HOPD Prospective Payment System* (PPS) using *ambulatory payment classification* (APC) codes;
   (b) *Operating expense synergies*, e.g., the historical operating expense burdens associated with the target entity's billing staff may be reduced due to the *redundancy* and *reduplication* in the services that an acquirer may already provide; and,
   (c) *Capital expenses synergies*, e.g., the fixed costs per patient related to an *electronic health records* (EHR) system may be reduced due to an increase in EHR utilization resulting from the anticipated transaction; and,

(2) *Determining the risk adjusted required rate of return* for a *particular buyer* inclusive of factors that may *not be available* under the FMV assumption of a *universe* of buyers, sellers, owners, and investors, such as:
   (a) *Operating risk reductions*, e.g., decreases in risk which may result from a diverse, multispecialty integrated health system acquiring a focused, single specialty free-standing physician practice;[99] and,
   (b) *Financial risk reductions*, e.g., a large integrated health system may enjoy greater access to capital and, thus, a lower cost of capital than a small free-standing physician practice.[100]

It should be noted that valuation analyst must take care to *avoid double counting* when considering the various *net economic benefit synergies* and *risk synergies* described above. For example, if a reduction in the target entity's billing staff is projected, then valuator may wish to consider increasing the *operating risk return* to reflect the additional risk required to attain the projected billing staff levels.

When performing a *cost/benefit analysis* for a *particular buyer*, a valuation analyst may also wish to consider the *value metrics*, which result from the application of one or more of the following analytical methods, to serve as a basis for a CR opinion related to an anticipated transaction:

(1) *Net present value (NPV) analysis*, which examines the total *expected risk-adjusted future net economic benefits* (e.g., present value of the future net cash flows) arising from the total *initial economic expense burdens* (e.g., initial cash outlays);[101]

(2) *Internal rate of return (IRR) analysis*, which contrasts an organization's *risk adjusted required rate of return* (or hurdle rate) against the *discount rate* that, when applied to the *expected future net economic benefits* of the subject property interest, results in a **zero** *net present value;*[102]

(3) *Average accounting return (AAR) analysis*, which determines the average of the *net income* arising from the assets or services to be acquired in the anticipated transaction *for each discrete accounting period*, divided by the book value of those subject property interest(s) acquired *for each of the corresponding accounting periods;*[103]

(4) *Discounted payback period analysis*, which is similar to a *payback period analysis*, calculates the number of discrete periods *"…until the sum of the* ***discounted*** *cash flow is equal to the initial investment;"*[104] and,

(5) *Payback period analysis*, which calculates the number of discrete periods necessary for *"the cumulative forecasted [undiscounted] cash flow [to] equal the initial investment."*[105]

Each of the *value metrics*, which results from the *cost/benefit analyses* described above, should be considered within the context of the *qualitative factors* of the CR analysis.[106] This is especially true when the *cost/benefit analysis* reflects a financial loss, as a transaction may still be *commercially reasonable* after the *non-monetary benefits* that may arise from the anticipated transaction are taken into consideration. For example, the benefits produced by a transaction that result in an expansion into new geographic areas and/or new service lines, or an improvement in the access to technology and/or innovation, may provide substantial evidence of a prudent business decision, i.e., *commercial reasonableness*.[107] In approaching any of these *quantitative* techniques, analysts should note that *tax-exempt not-for-profit healthcare organizations* operate in service to their *stated charitable mission* and, in lieu of taxes, provide a *social benefit*, which also may serve as justification for a certain level of financial loss resulting from a cost/benefit analysis of an integration transaction in the aggregate (as previously discussed in the Qualitative section, above).

Conclusion

In today's healthcare delivery system, hospitals have an expanded scope of responsibility to be the integrators and coordinators of care for their market service areas, often serving as the only and last resort of critical care in the health and well-being of their communities. In these instances, non-profit, tax-exempt entities may enter into prudent, sensible business transactions to create a social benefit *"in furtherance of [their] charitable purpose,"* which, as previously mentioned, may necessitate an integration support payment that results in a financial loss.[108]

Mastering the foundational principles for a CR analysis – including accurately understanding the definitions of CR, as well as the differences between a FMV opinion and a CR analysis – is essential.[109] In an era of increasing regulatory scrutiny and growing healthcare transaction volume, proper consideration of the CR threshold, within the *qualitative* and *quantitative* aspects of a CR analysis, can increase the defensibility of an opinion that the proposed transaction is in regulatory compliance, including whether the anticipated transaction takes into consideration "*value or volume of referrals.*"[110] In addition, a transaction that is *financially feasible* under the *quantitative analysis* may not necessarily be *commercially reasonable*. A *qualitative analysis* should also be performed as part of the CR determination.

Should you have any questions regarding *commercial reasonableness opinions*, please do not hesitate to contact Health Capital Consultants at (800) FYI – VALU [394-8258], or via email at solutions@healthcapital.com.

(Continued on next page)

EXHIBIT 1: THE COMMERCIAL REASONABLENESS OPINION
HURDLING THE ANALYTICAL THRESHOLDS

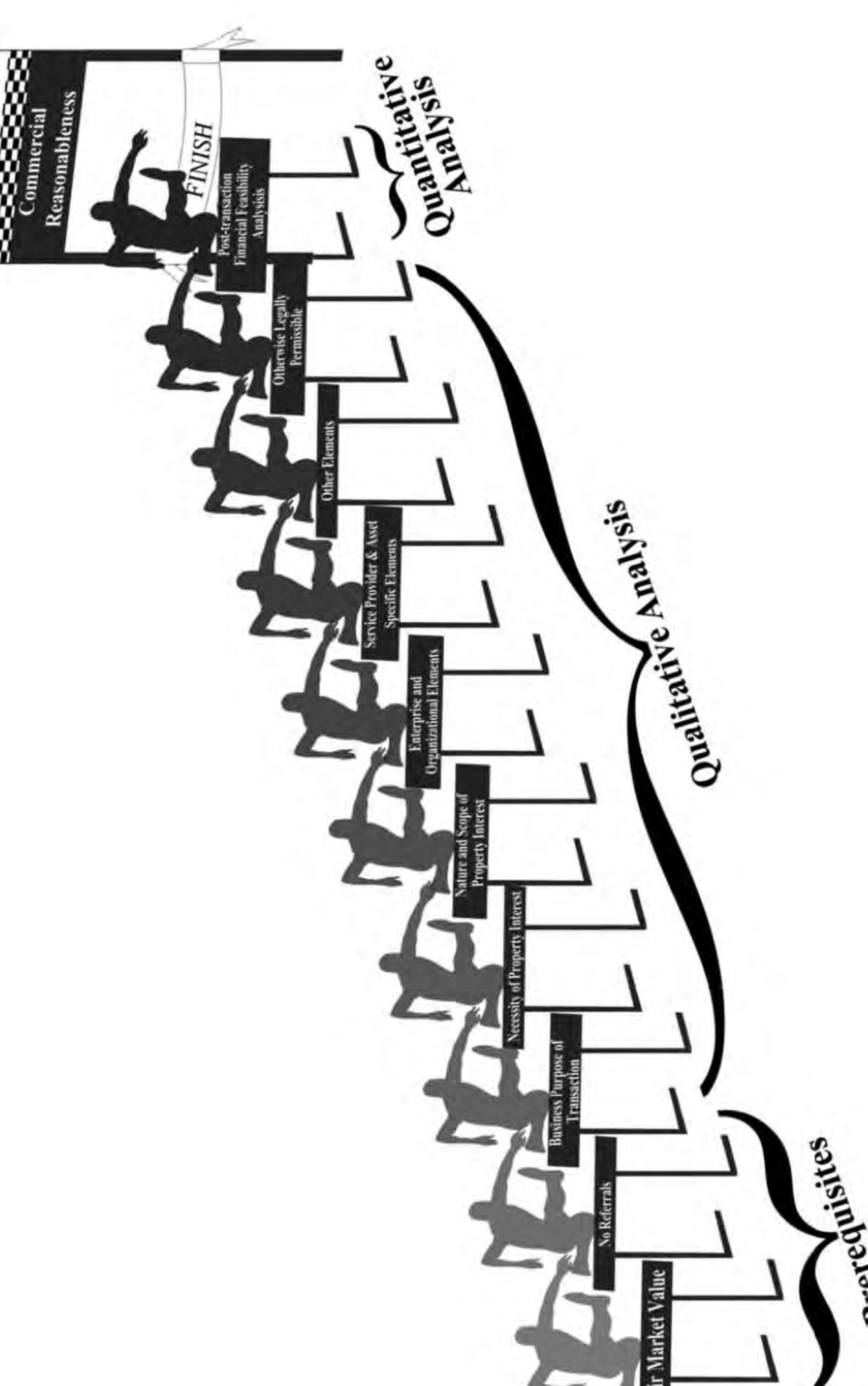


EXHIBIT 2: QUALITATIVE ANALYTICAL STEPS IN THE COMMERCIAL REASONABLENESS THRESHOLD

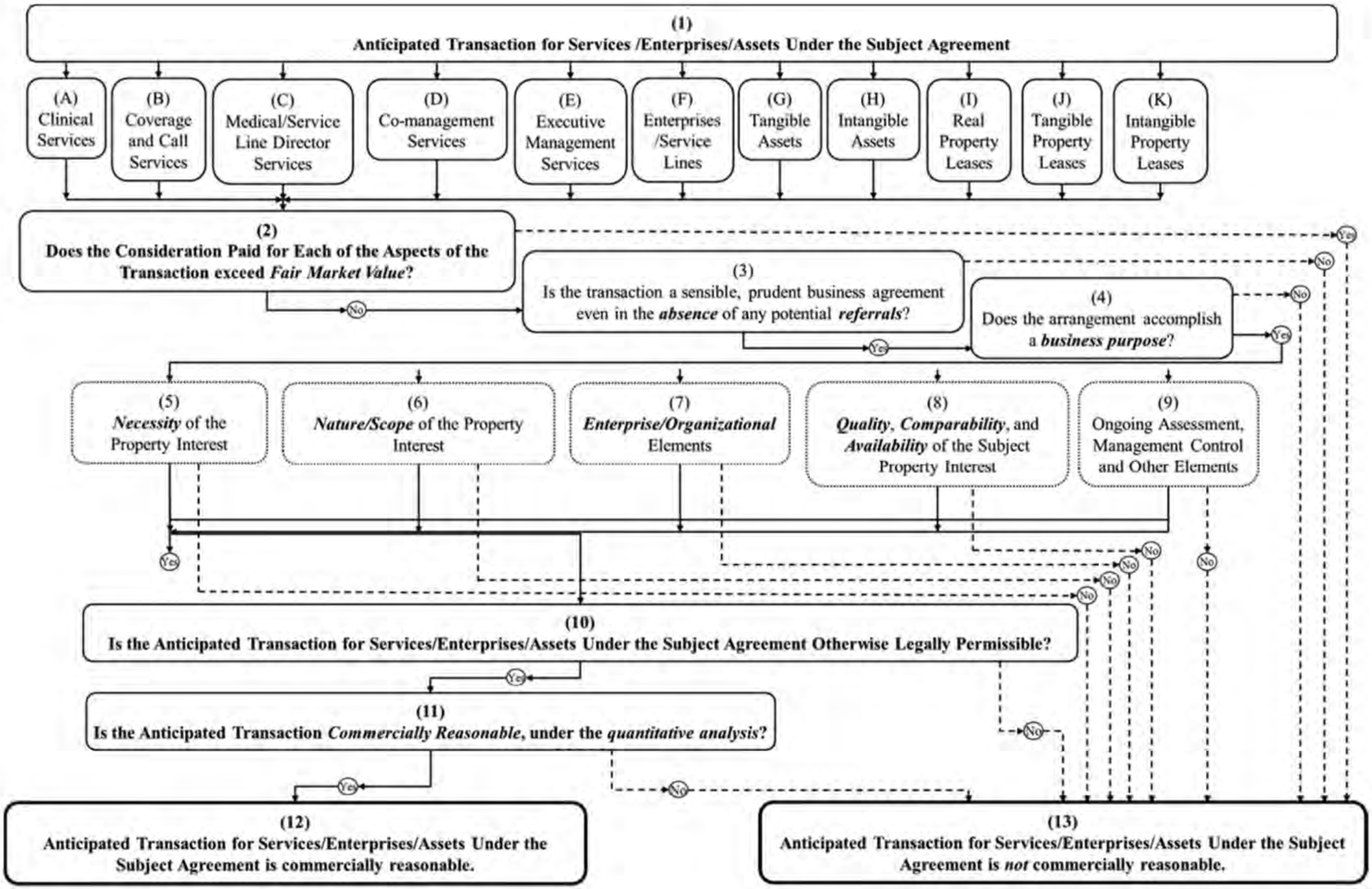


EXHIBIT 3: ANALYTICAL PROCESSES FOR ASSESSING THE NECESSITY OF THE SUBJECT PROPERTY INTEREST

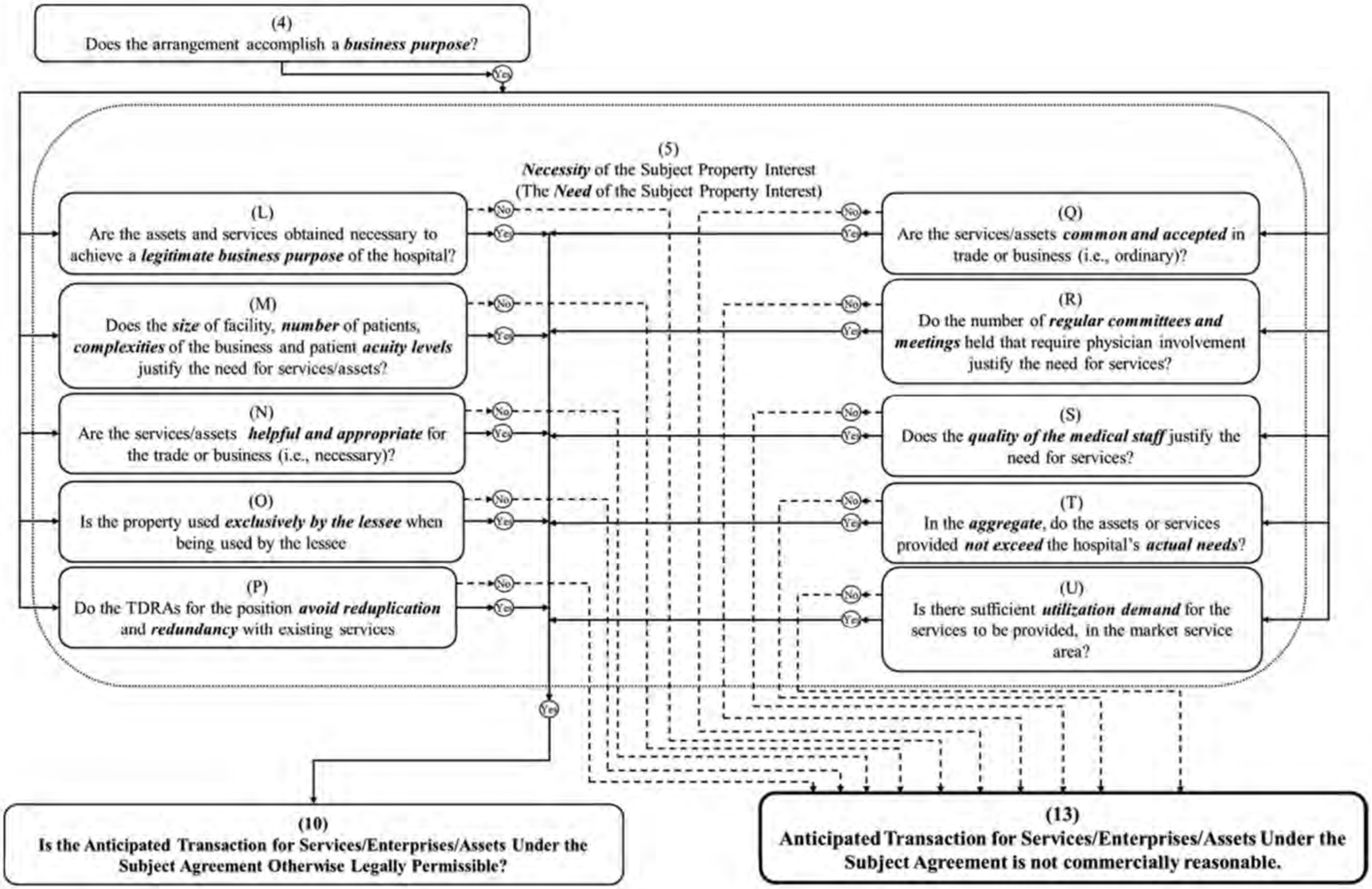


EXHIBIT 4: ANALYTICAL PROCESSES FOR ASSESSING THE NATURE & SCOPE OF THE SUBJECT PROPERTY INTEREST

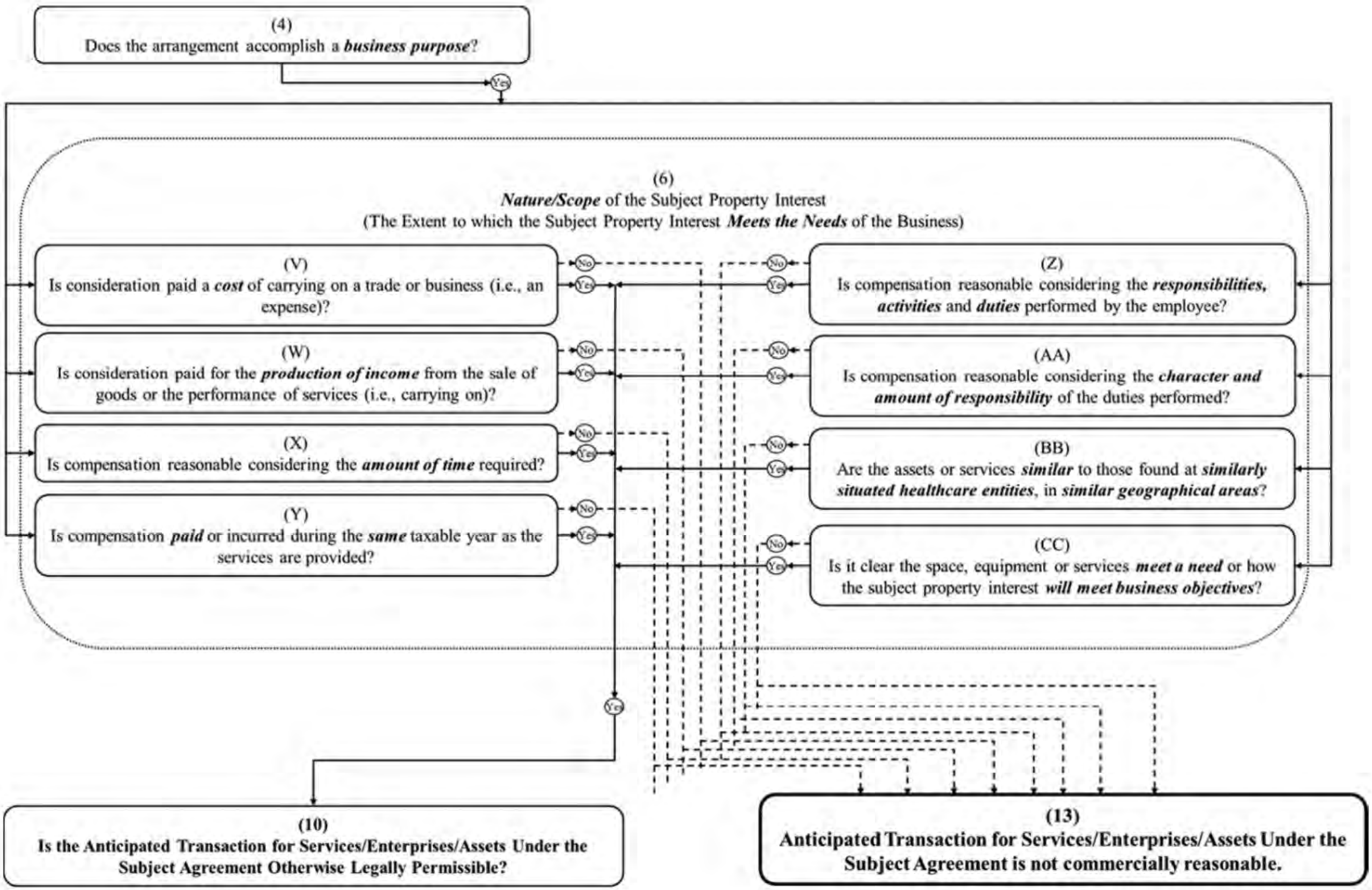


Exhibit 5: Analytical Processes for Assessing the Enterprise & Organizational Elements

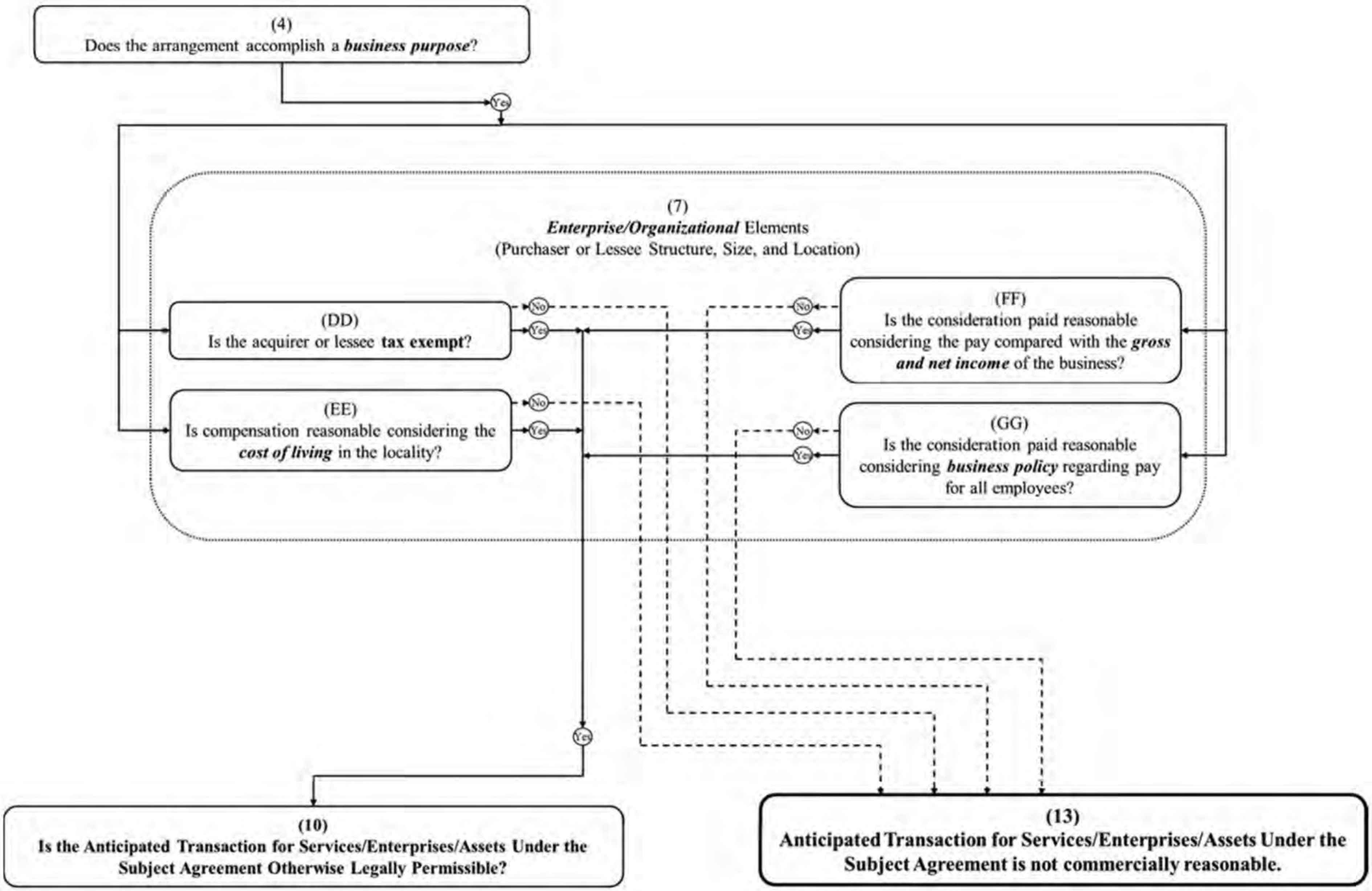


EXHIBIT 6: ANALYTICAL PROCESSES FOR ASSESSING THE QUALITY, COMPARABILITY, & AVAILABILITY OF THE SUBJECT PROPERTY INTEREST

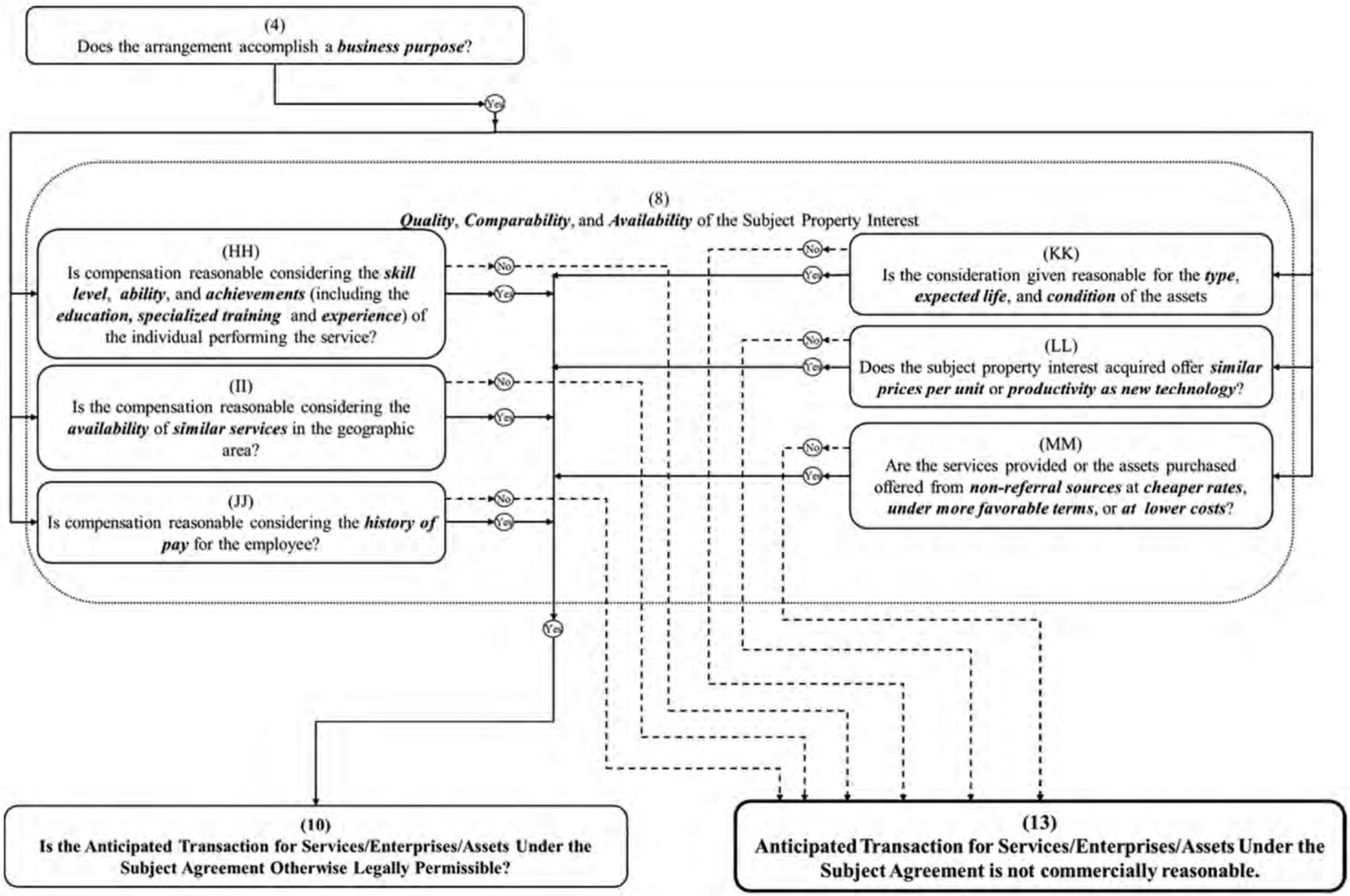


EXHIBIT 7: ANALYTICAL PROCESSES FOR ASSESSING THE ONGOING ASSESSMENT, THE MANAGEMENT CONTROL, AND OTHER ELEMENTS

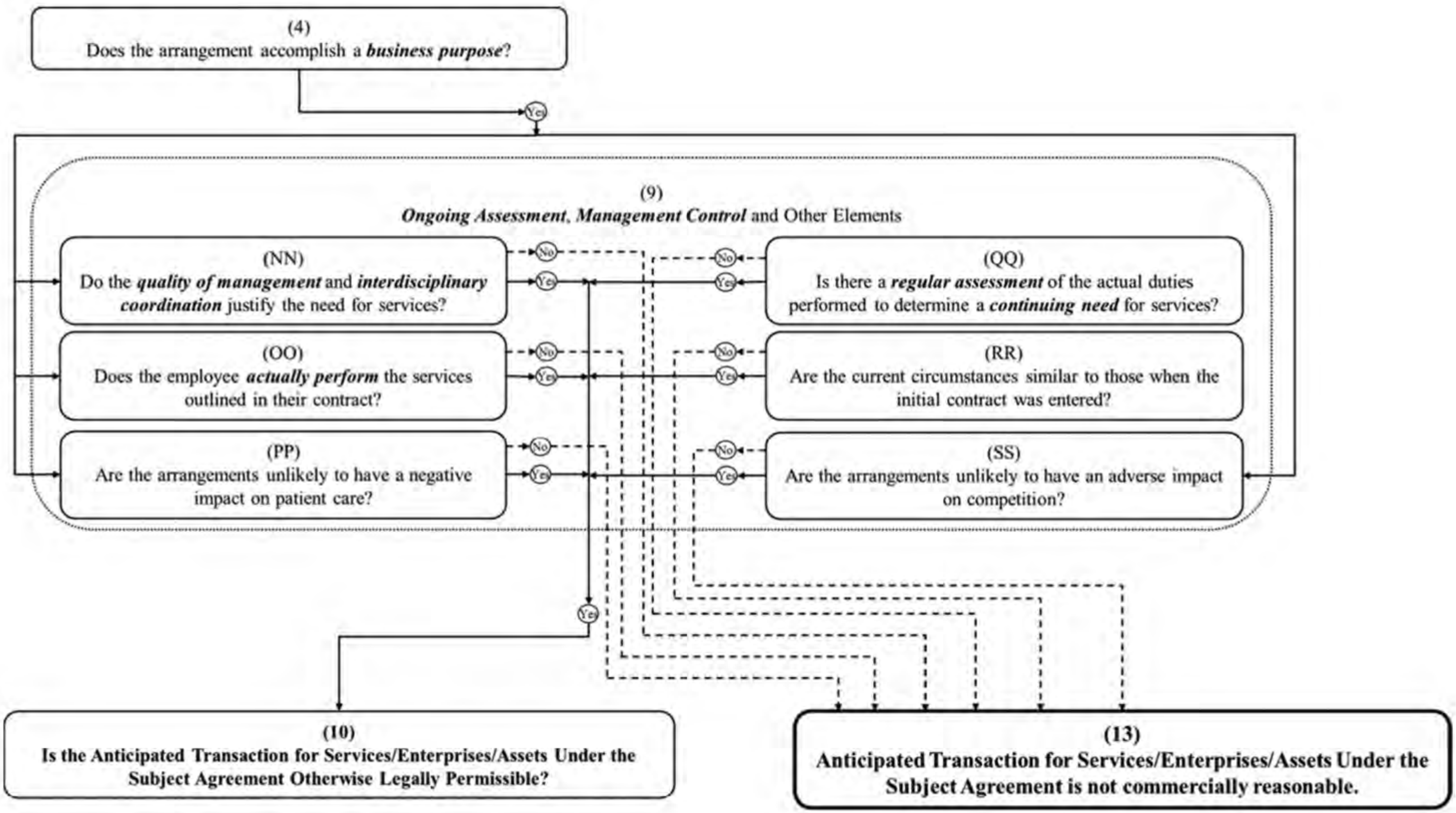
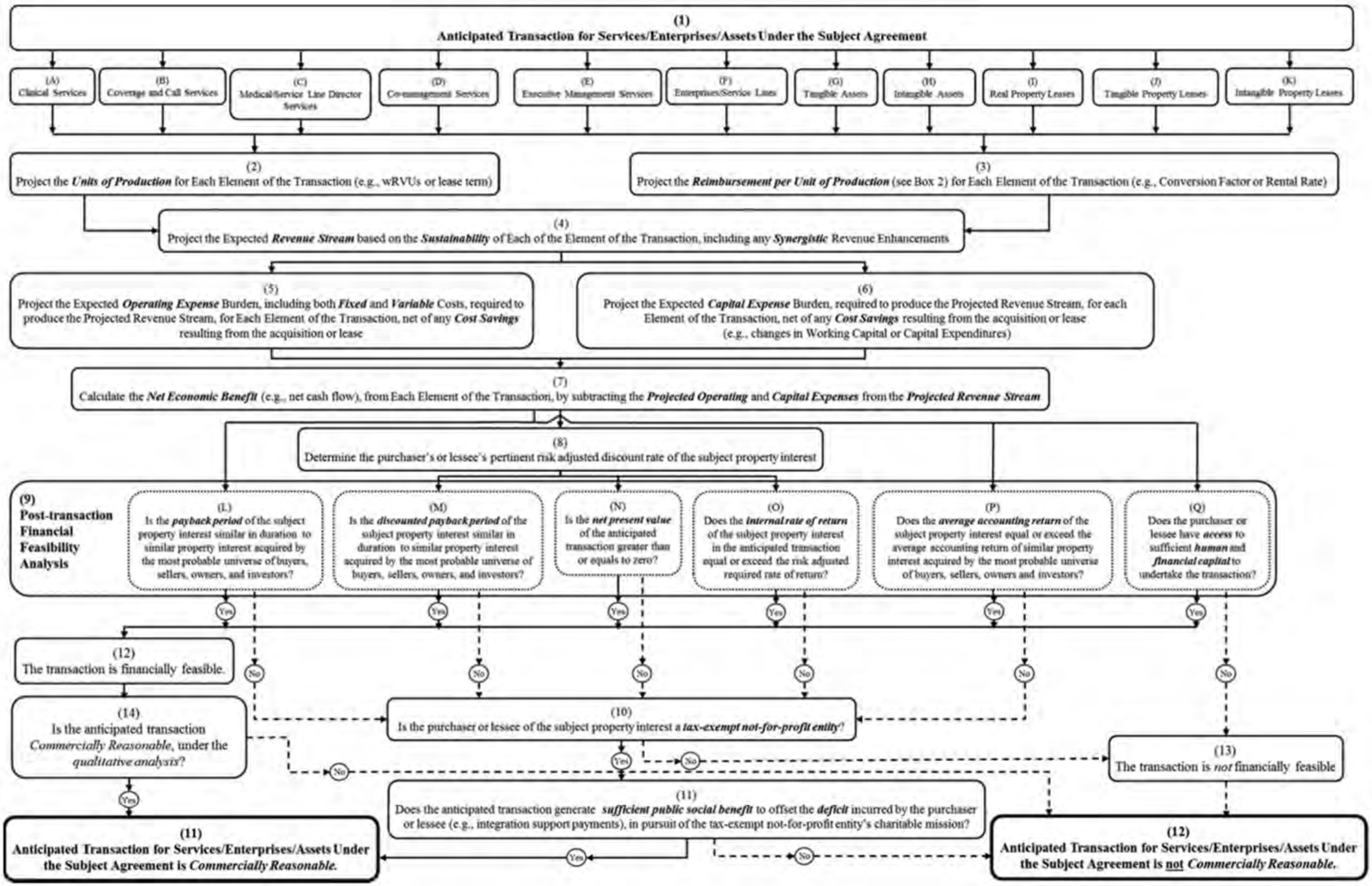


EXHIBIT 8: ANALYTICAL PROCESS FOR THE QUANTITATIVE ANALYSIS



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