From Pro Forma to Proactive

As hospitals buy physician practices, board compensation oversight must shift into high gear

By Chris Terranova Asselta and Timothy C. Reed

As health care organizations evolve and compensation models shift, board review of physician compensation increasingly is under scrutiny. In some cases, organizations can be penalized. For example, a health system in the Midwest paid a $4.5 million settlement pertaining to five physicians who allegedly were paid two to three times market value. Another system faced a $30 million settlement for alleged improper lease and independent contractor arrangements.

In addition to actions brought by the Department of Justice, whistleblowers can make claims, some of which are spurious. On top of the cost of addressing such claims, the organization's reputation can be damaged.

Fortunately, there are best practices for boards to use in evaluating physician compensation, exercising due diligence and ensuring high standards of fiduciary oversight.

Changing Models

More physicians are accepting employment or merging their practices with health care organizations. In addition to provisions for base salaries, agreements commonly involve signing bonuses, incentive bonuses, nonqualified deferred compensation, severance, retention provisions and forgivable loans, all of which should be subject to fair market value evaluation, both as stand-alone arrangements and cumulatively in terms of their impact on total compensation (value of all cash and benefits arrangements).

These acquisitions are taking place in the context of evolving care delivery and reimbursement models. As the industry shifts from paying for procedures to paying for quality, efficiency and outcomes, compensation for physicians will shift from volume to value. It is relatively simple to link compensation to service volume: more procedures equal more pay. It is considerably more challenging to tie compensation to outcomes. And, these new models also mean that organizations will have to develop new measures of success.

All these changes make a carefully planned, conscientiously documented approach to compensation more important than ever.

Be 'Reasonable'

To meet their fiduciary obligations, boards must ensure that physician compensation levels are set at FMV, the volume and value of referrals are excluded from the value of a physician's practice, and business transactions leading to physician acquisition or employment are commercially reasonable. Thus, FMV and commercial reasonableness demand special attention from executives and, in certain circumstances, the board.

FMV is commonly defined as "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."

Stark law further emphasizes that the transaction needs to be at arm's length; that is, that one party is "not otherwise in a position to generate business for the other party." The Office of Inspector General has not set specific standards that define FMV, but has stated that "reference to multiple objective, independently published salary surveys remains a prudent practice." Therefore, boards are advised to do their homework when evaluating and approving physician compensation arrangements and ensure that multiple compensation benchmarks are considered.

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Commercial reasonableness addresses the prudence of the business transaction from a commercial and financial standpoint. While regulations do not define criteria or standards for determining which physician compensation arrangements are commercially reasonable, boards should consider reviewing a multiyear pro forma for a physician practice, because a business transaction that results in recurring annual losses could raise questions about whether it is commercially reasonable.

What Boards Can Do

Given the very real responsibility trustees now have for physician compensation, they should take the following steps.

• **Educate themselves.** This includes both broad fiduciary oversight responsibilities and emerging trends.

• **Ensure proper oversight.** Create a discrete committee of disinterested (or independent) board members supported by key management team members, such as the chief legal counsel, to carry out these responsibilities.

• **Develop governance documents and process.** Define a philosophy that will provide high-level parameters for any given agreement.

• **Determine which arrangements require review.** A starting point might be compensation for department chairs, all agreements over $500,000, or all agreements in a given percentile (say, the top 25 percent).

• **Conduct a program audit.** Clearly identify business judgment factors that the board and organization will rely on to evaluate arrangements with physicians, such as unique skills and recruitment challenges. Elaborate on your philosophy of FMV and commercial reasonableness. Assess the risk associated with compensation strategies. Ensure that quality-based criteria for compensation are considered and developed in response to the shift toward value- or outcomes-based reimbursement from third-party insurers.

• **Engage early with transactions.** Having documentation ready and reviewed early in the process can preempt missteps later on.

• **Update the full board.** While the designated committee handles the details, keep the full board informed, especially of any high-risk agreements. For compensation arrangements that are likely to receive media attention, prepare talking points for board and committee members to use if approached by the press or organization stakeholders.

Finally, trustees should be able to answer the following five questions.

1. Who has oversight?
2. Who is covered?
3. What is the physician compensation philosophy?
4. How do we monitor/audit compliance?
5. How can compensation change?

Overseeing physician compensation arrangements is now a clear board responsibility. Effective boards will get up to speed quickly on the best practices to follow as they discharge those responsibilities. T

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