Buy/sell agreements

Special article reprint

for Medical Group Management Association (MGMA)
Health Care Consulting Group clients

This special reprint is a collection of articles from the MGMA Connexion™ publication, the key resource in the industry for practice managers. Use the information to deal appropriately with buy/sell agreements. Take a look. Apply the strategic considerations, financial considerations and legal considerations of buy/sell agreements.
The buy/sell agreement is not an isolated event; it is an integral part of the group’s strategic fabric. If your group is considering a new buy/sell agreement or a revision of an existing agreement that is vague or unworkable, seek an agreement that will support the following criteria:

• The values and mission of the group — If these are not articulated formally, do so before proceeding;

• The goals and objectives of the group — Similarly, these form an important reference point;

• The business plan or direction of the group — This need not be elaborate, and many successful groups operate without a formal plan, but most successful practices have a clear, collective sense of direction;

• The succession/recruitment plan — A buy/sell agreement is of little practical value if it inhibits either expansion and/or succession; and

• Current reality — Many young physicians look at a buy-in as the cost attendant to the opportunity to practice with your group.

The seller’s thinking

The seller’s thinking about a buy/sell transaction will be influenced by two considerations. First, if the terms of a pre-existing buy/sell agreement — financial and otherwise — are spelled out clearly. This usually promotes an easy transaction, following the terms, with little left to negotiate. Both the seller and the buyer agree to conditions from the time of initial employment and/or negotiation of the agreement.

Second, if the terms of a pre-existing buy/sell agreement are not spelled out clearly. The most prevalent omissions are lack of either a set dollar price or a specific methodology to arrive at the transaction price. This all-too-common situation can lead to protracted negotiations about valuation methodology and price.
The buyer’s thinking

The buyer generally approaches a buy/sell event with one of two perceptions. S/he may feel comfortable with the terms of an existing buy/sell agreement, known since the time of employment. This is the ideal situation. Conversely, the buyer may feel uncomfortable and uncertain if terms and valuation methodologies are unknown. This occurs when a buy/sell agreement is vague or ambiguous, or when such an agreement is completely absent. This situation often leads to protracted negotiations about valuation methodology and price.

The ideal common mindset

Certain attributes and actions lead to the most effective decisions about buy/sell agreements and resolutions of disputes:

- Everyone (almost everyone in large groups) believes the buy/sell agreement represents a “fair shake”;
- The group sets strategic, financial and organizational direction and then consults legal and other experts early in the process;
- The group is amenable to reasonable changes in response to environmental considerations; and
- Prospective buyers — ideally when they are candidates for employment — obtain their own expert advice on the buy/sell agreement.

In a perfect world

In a perfect world, the buy/sell agreement will:

- Be in place long before it is needed, clearly spelling out the financial terms and conditions of the event;
- Describe the conditions and terms of events that can be anticipated, such as physicians joining the group or retiring; and
- Define the conditions and terms of buy/sell events that occur randomly, such as death, disability, divorce, early retirement and voluntary or involuntary separation.

In the real world

In the real world, buy/sell agreements have no right or wrong structure, no universal formula that applies to all groups. Every group is different. However, certain approaches seem to work better than others — call them best practices. The following conditions exist in virtually all groups that have developed effective and enduring approaches to the buy/sell question:

- The buy/sell agreement is consistent with the group’s mission, goals and objectives;
- The terms of the buy/sell agreement support the overall strategy of the group, permitting relative ease of admission for new members and transition of departing members;
- The terms of the buy/sell agreement are integrated with other economic components such as the income distribution system, profit-sharing strategy, retirement plans and other benefit programs. From a financial standpoint, the terms are man-

The buy/sell agreement is part of the organization’s fabric, not an isolated financial transaction.
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- The buy/sell agreement or agreements (there may be more than one) are structured to reflect the asset base of the group. For example, some groups have a single buy/sell agreement for a single entity; others have multiple agreements for multiple separate but related entities, such as real estate, other interests/investments or practice assets that may be considered personal by each physician.

History and recent trends

Until the 1960s, the proceeds from the sale of a practice might constitute a significant portion of a retiring physician’s retirement portfolio. Back then, a buy/sell agreement often reflected not only a stated concept of value for membership or partnership in the practice but also the unspoken mechanism whereby one was admitted to a “guild.”

In this model, the new physician served an economic apprenticeship, generating a profit for full members. On completion of the apprenticeship — and for an additional payment — the new physician could join as a full member of the enterprise. The buy/sell agreement could assign or impute a large goodwill or intangible asset value to the transaction.

The environment for buy/sell agreements certainly has changed in the last 40 years. Now:

- New physicians typically carry heavy consumer and educational debt by the time they complete their training;
- New physicians often have multiple practice opportunities, depending on the specialty;
- Many young physicians look at a practice as a place to work and earn income, not as an equity investment opportunity;
- Medicine is no longer a “mom and pop” business. Most care is paid for by large, third-party payers with the ability to set prices;
- Few physicians consider their equity interest in a practice to be a significant component of their retirement portfolio. Most believe they will obtain almost all of the economic value of their practice through annual earnings. In other words, they earn their money as they practice their profession, not from a transaction at the end of their careers; and
- Modest buy/sell transactions are growing in popularity — with predetermined terms at both the buy and sell decision points.

Any group contemplating the development or revision of a buy/sell agreement must have a realistic view of the world.

Strategic considerations and common arrangements

Buy/sell agreements ultimately reflect their organizations and their culture. The buy/sell agreement for a small primary care group in rural Maine will differ from a buy/sell agreement for an aesthetic surgery practice in Beverly Hills, Calif. Similarly, the buy/sell arrangements for a general internal medicine practice in Columbus, Ohio, will differ from the buy/sell agreement for a single-specialty surgery group in the same city.

Every group will require the services of an attorney to draw up the agreement and ensure its legal execution. The services of a management consultant may be necessary if the group cannot address the strategic and financial issues sufficiently to establish a business base for the buy/sell terms; you
may need tax counsel for income tax considerations. The group should base its decisions on objective criteria that support its future success. Seek expert legal and financial advice to get it.

The need to exercise a buy/sell agreement usually occurs either when the practice invites a practitioner to become an equity stakeholder or when someone retires. A buy/sell agreement may involve only a practice entity, its accounts receivable and hard assets, while another may include high-value real estate or sophisticated technology. Regardless of what you buy, you are generally required to sell exactly the same interests as you purchased.

Buy-in arrangements may take one of the following forms:

- Mandatory buy-in to a practice corporation or partnership;
- Mandatory buy-in to related businesses, such as real estate or equipment entities;
- Less commonly, mandatory buy-in to the practice entity, optional buy-in to real estate or equipment entities. This is a problem when too many individuals elect not to buy in to the related entities; and
- Rarely, mandatory buy-in to the practice entity but restricted access to equity participation in related entities. This arrangement is nondemocratic and not particularly attractive to new physicians.

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A buy/sell agreement’s structure dictates the way a physician will purchase and sell his/her equity interest in a medical group. Some arrangements are simple and exact: The buyer writes a check going in and receives a check when selling the equity interest.

Other buy/sell arrangements use indirect or inexact methods of payment that can involve forgone income (using pretax dollars) and salary continuation following retirement. These more complex approaches are more prone to ambiguity. They can spark disagreement among buyers and sellers if not clearly addressed.

A discussion of this matter is beyond the scope of this article, but the issue has bearing on how buy/sell agreements cover — or fail to cover — financial matters. While a group may have valid reasons for lack of specificity in certain areas of the agreement, realize that, in general, lack of specificity can create future problems.

Valuation

Many buy/sell agreements stipulate that the transaction will be guided by a valuation at the time of sale. Valuation is an ostensibly quantitative and quasiscientific exercise intended to produce an economic concept of price or value. Because valuation methodologies are largely arithmetic, the valuation process carries a mystique that implies precision.

However, subjective factors play a large role in most valuation scenarios, and methods can be manipulated to influence the conclusions. The following brief discussion of valuation matters relates only to the dynamics of valuation that apply to buy/sell transactions between physicians and medical groups; a different set of economic and marketplace dynamics apply to transactions with external parties, such as health care systems and other entities.

The real goal of the valuation component of a buy/sell agreement should be to establish terms acceptable to the buyer(s) and seller(s); this can be defined as fair market value. This meshes with the definition established by the Internal Revenue Service in Revenue Ruling 59-60: “… the amount 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, and both parties have a reasonable knowledge of relevant facts.”

A medical group has only three elements of value:

- Hard assets: Physical items such as buildings, furniture and equipment;
- Accounts receivable; and
- Goodwill or intangible assets.

The value of furnishings and equipment usually is based on either book value or appraised value. The value of accounts receivable also is relatively simple to calculate, since most groups have a firm handle on net collection rates.

Intangible asset value or goodwill presents a more difficult valuation challenge. This is a subjective concept of value attached to the existence of a going concern. How do you measure an organization that has intrinsic value, the opportunity cost to avoid an independent practice start-up and other perceived elements of value?

Although historically, the buy-ins of many groups have included hefty payments for goodwill, the distinct trend in recent years has been away from large goodwill buy-ins and toward minimal or no payments for intangible asset value. The primary reason: a change in the dynamics of the marketplace. Young physicians with multiple practice opportunities are increasingly unwilling to pay for significant amounts of goodwill in a buy-in.

Where a group deems it necessary to use a valuation process to determine price at either the buy and/or sell point, the most effective arrangements:

- State the precise valuation methodology in the buy/sell agreement, consistent for both the buy and sell events;
- Delineate the assumptions to be used in the valuation process; and
- Articulate the consideration to be given intangible asset value. The method of computation for arriving at intangible asset value is spelled out clearly.

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**Common valuation methods**

Valuation methodologies and formulas abound. The three major categories of valuation methods that apply to medical practices are:

- Fixed price — A set price is agreed to for both the buy and sell portions. The agreement usually requires a regular adjustment of the price based on an agreed-upon and consistent methodology.
- Balance sheet — Used to determine value. This obviously can be problematic when the cash basis of accounting is used.
- Income — Various methods that may use earnings or cash flow to determine value based on income.

Other methods are used to establish a concept of value for equity in real estate and equipment-owning entities. They usually are designed to meet specific organizational considerations and reflect careful and comprehensive overall financial planning.

**Common buy/sell arrangements**

The financial arrangements for buy/sell agreements generally fall into three categories or some combination of these:
The buy/sell transaction should not unduly inhibit succession or the growth and general health of the group.

What determines success?
Experience has shown the following characteristics of buy/sell agreements’ design and management:

- They serve the long-term strategic interests of the group (this implies that the group is an organization designed to operate in perpetuity);
- Both methodology and price are established upfront for both the buy and sell components, with a consistent approach for the two components;
- The buy/sell agreement spells out in specific dollar terms the consequences of both the buy and sell parts;
- The buy/sell agreement spells out the buy part in specific dollar terms and defines the method — but not the specific dollar figure — for calculating the sell part of the transaction; and
- A vague agreement spells out neither the dollar terms nor the methodology for either the buy or sell portions.

- The money to be realized from the sell part of the transaction is not a part of any physician’s retirement planning, except for real estate interests;
- The price of the transaction is not an unreasonable financial burden for the buyer, the seller or the group;
- The buy/sell transaction should not unduly inhibit succession or the growth and general health of the group;
- The agreement is a part of a “full citizenship” approach, in which everyone invited to become an equity holder is able to purchase an equal share and an equal vote; and
- Intangible asset value, or goodwill, is treated in a manner that is consistent with the specialty, location and realities of the marketplace.

Problems related to buy/sell agreements typically occur when the group has not given enough attention to the issue in advance or has not revised the agreement to reflect changing conditions.
Clean dealing

Legal considerations for buy/sell agreements

Editor's note: This is the third and final in a series on medical practice buy/sell agreements. The first article focused on strategic aspects (September 2002 MGMA Connexion, page 54). The second article described financial issues (October 2002 MGMA Connexion, page 60).

Buy/sell issues generally involve economic and other rights — benefits and burdens associated with ownership or partnership in a medical practice. Physicians who buy into the practice gain certain rights and opportunities; those who are bought out also typically receive certain monetary and other benefits, while ceasing to enjoy other perquisites and burdens associated with ownership.

Buy/sell arrangements are typically thought of in dollars and cents. Yet buy/sell arrangements also relate to fundamental issues of governance and power. A clear benefit of medical group ownership is an enhanced legal right to vote on important decisions. A practice should consider strategic, financial and legal issues in the buy/sell arrangement and express them in the group’s legal documents.

Applicable law

Buy/sell arrangements are generally governed by the law of contracts. The contour of permissible arrangements will also, however, be shaped by state law relating to the medical group’s form of organization, such as professional corporations, limited liability companies and partnerships. Other federal and state laws will also potentially affect the arrangement, including:

- State medical practice act and “corporate practice of medicine” laws that restrict ownership in the group to certain licensees;
- State divorce and domestic property laws that may give a former spouse a right to a portion of the value of the practice;
- Confidentiality laws affecting the treatment of patient records;
- Laws governing noncompete agreements and “liquidated damages” provisions;

About the author

Bruce A. Johnson, JD, MPA, MGMA Health Care Consulting Group principal and special counsel, Faegre & Benson, Denver, baj@mgma.com
A practice should consider power and money issues in the buy/sell arrangement and express them in the group’s legal documents.

- Patient abandonment statutes that may require patient notification when a physician leaves the group (notwithstanding a noncompete agreement);
- State and federal laws governing the purchase and sale of securities;
- Laws and rules related to malpractice insurance and professional liability; and
- Federal and state antidiscrimination laws that may invalidate certain transfer restrictions, such as those restricting transfer based on ethnicity or gender.

Assuming that the medical group’s physicians have reached closure on the underlying buy/sell business terms, the parties’ agreement regarding the power and money issues should be reflected unambiguously in legal documents and integrated into a coherent whole.

The basics of practice buy-in

Practice buy-in arrangements are typically designed to provide fair value to the physicians who built the group, allow new physicians to join the practice, ensure equitable (consistent) treatment of physicians and promote the timely completion of the transaction.

Most medical groups set a defined time of employment — usually one to three years — after which they can offer ownership. Practices and physicians may seek to freeze specific terms of the buy-in but take care to ensure that ownership in the group is not guaranteed.

Thus, when a new physician signs an agreement that says s/he “will be considered and evaluated” for ownership in the group after a defined period, the provision should also say clearly that shareholder status is not promised or guaranteed, unless such legally enforceable promises are genuinely intended at the outset.

A buy-in agreement requires considerable paperwork. The names of the legal documents may vary based on the group’s form of legal entity, jurisdiction, local legal customs and other factors, but the principal forms and the common terms addressed in each include:

- **Corporate bylaws governing the practice** — Define governance and other rights associated with stock or other equity ownership;
- **Shareholders’ or buy/sell agreement** — Places restrictions on the transfer of stock in the practice. Defines the stock buy-out calculation method and terminating events leading to buy-out (such as death, termination of employment and disability). May also consider deferred compensation or other value relating to accounts receivable (A/R);
- **Physician employment agreements** — Link buy/sell terms to the group’s physician compensation system. May address rights to a portion of A/R upon termination and other continuing obligations, such as noncompete agreements and post-termination access to patients’ health information; and
- **Stock purchase agreement** — Defines the stock (equity) purchase price and payment terms, and wraps together the stock purchase transaction.

Perfecting the buy-out portion of the agreement

For most groups, the pragmatic goals in buy-out arrangements include a fair deal for physicians who leave the practice, equitable and consistent arrangements, and maintaining the group’s future viability.

A group’s shareholders’ or buy/sell agreement will typically impose restrictions on the transfer and sale of the group’s stock, define the terms of buy-out and include other provisions. Many of those transfer restrictions are mandated by a state’s medical practice act or laws governing the form of organization. The buy-out arrangement will generally consider the same core issues addressed in the buy-in: stock, share of A/R, other value, continuing rights or obligations owed by the group to the physician (or the
Key questions and considerations related to buy-in transactions include:

- What percentage interest in the medical practice is the physician purchasing? Does the physician enjoy that interest immediately, or is s/he subject to a vesting requirement as longevity with the group increases?
- From whom does the physician purchase the interests? The medical group or the group’s individual owners? What are the tax consequences of the method employed?
- What rights, if any, will the physician have in accounts receivable (A/R) existing as of the date stock ownership commences? How does that interest relate to the medical group’s compensation system?
- What rights will the physician have to A/R generated after s/he purchases the stock?
- How is the purchase price paid? Most groups require physicians to purchase the stock portion of the buy-in with cash at the time of sale. Some groups use differential compensation arrangements — in which the new physician receives a portion of a full partner’s total compensation — or a period of time to pay for a buy-in with pretax dollars, while others require new physicians to pay their entire obligation in cash with post-tax dollars. Still others require the physician to obtain a commercial loan to pay the buy-in immediately.
- Any buy-in will be subject to various additional requirements, including the preparation of appropriate legal documents, defined effective dates for the transaction, corporate resolutions and minutes, promissory notes and regulatory filings.

Buy-out questions

Key questions in structuring effective buy-out arrangements include:

- What “triggering events” will lead to a mandatory sale of the interests, such as death, termination of employment, disability for a defined period or personal bankruptcy?
- What is the purchase price for the stock or equity in the group, and how will it be determined? How will it be calculated depending on types of triggering events? Will it vary depending on the physician’s tenure with the group?
- Will the stock purchase price be paid immediately or over a defined period following the triggering event? A practice typically provides an interest-bearing promissory note when payments occur over an extended period.
- Apart from accrued salary, is there any other value that the physician receives upon termination, such as a share of receivables collected after termination?
- What considerations, if any, does the practice make if the A/R payout harms the group’s cash flow — and the remaining physicians’ compensation? Are there safeguards to protect the group? Some practices prescribe a ceiling on the total annual pay-out to departed physicians to protect the remaining doctors.
- What is the tax treatment for the different pieces of the puzzle? Upon transfer, gain realized in the value of a practice’s stock will be subject to tax, just as any appreciated asset. The treatment of other assets, such as A/R paid in the form of deferred compensation, will have different implications. For example, deferred compensation arrangements will most likely be taxed as ordinary wages and as such will be subject to liabilities of the Federal Insurance Contributions Act and other withholding-tax laws.
- Does the arrangement consider the possibility of partial buy-out of the stock or the conversion of the departed physician — or his/her estate — to “economic interest only” status for some period following termination?
- What other protections should be included in the transaction? If a non-compete and/or liquidated damages provision exists, how does it relate to the buy-out obligation? Is there a “right of offset” to give the group the ability to deduct the physician’s financial obligations to the group (such as for violation of a noncompete agreement or for purchase of malpractice “tail coverage”), from amounts the group may otherwise owe to the physician under the buy/sell arrangement?
- What are the parties’ continuing obligations after departure? For example, what is the physician’s obligation to pay an extended reporting endorsement (tail coverage) or to otherwise maintain professional liability coverage? Can s/he recruit the practice’s employees? What confidentiality or other obligations should continue after the physician is no longer a shareholder, such as personal guarantees on leases and bank loans?
- How does the arrangement address rights in community property states in the event of a divorce or otherwise deal with the possibility that people other than the physician may have an economic interest in the physician’s equity interest?
A group’s shareholders’ or buy/sell agreement will typically impose restrictions on the transfer and sale of the group’s stock, define the terms of buy-out and include other provisions.

Craft an agreement that suits your practice

To minimize costs or because of unfamiliarity with legal considerations, medical groups may seek a standard or boilerplate buy/sell agreement, but an entirely acceptable “off-the-shelf” agreement that meets a group’s unique goals and needs does not exist. Nevertheless, experience suggests that most buy/sell arrangements follow a form that addresses, on a case-by-case basis, the key business and legal considerations outlined in this article.

A practice should consider various statutory, tax and related issues in consultation with legal and accounting advisers in structuring buy/sell arrangements. Yet the hallmark of any effective buy/sell arrangement is the parties’ ability to draw up a contract that best suits their needs. Use legal and business counsel to provide expertise, document the deal’s terms and supply a “reality check” for the proposed transaction. Essential elements of an effective, written buy/sell arrangement generally will reflect:

- Simplicity;
- Valuation methods that can be replicated;
- Shared understanding among the parties of the essential deal terms; and
- Arrangements that consider and expressly address the essential components of a practice — stock or other equity, A/R, treatment of goodwill or “intangible value,” and effect (if any) on physician compensation.

Preparation of a well-defined, legally enforceable buy/sell agreement that achieves those goals can substantially enhance both individual and group financial security and professional cohesion.

The MGMA Health Care Consulting Group consultants have the essential skills to drive strategic thinking, organizational problem-solving and operational improvement.

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