Buy-In And Pay-Out Arrangements for Ophthalmology Practices

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* Financial Interest

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Who We Are

- Business and legal advisors to ophthalmologists and other physicians
- Handle and advise re: new doctor employment agreements, buy-ins, pay-outs, practice sales, valuations, income division arrangements, etc.
- Publishers of the Goodwill Registry, used in ophthalmology and other medical practice valuation
Buy-in Planning

- Plan ideally begins prior to first employment agreement
- Set expectations, outline terms
- But, no promises
- Critical evaluation, feedback, notice of problems
- Firing associates vs. divorcing a partner

More Than a Buy-in

- Four things happening simultaneously
  - Buy-in
  - Governance / Decision Making
  - Income Division
  - Pay-out

Formal Valuation of Practice?

- Not strictly necessary
- Review financials
- Ball park values usually involved
- Evaluate financial feasibility
Method and Structure for the Buy-in

• For the ease of understanding and illustration, assume the practice entity is a professional corporation
• But, the same basic principles apply to other types of practice entities

Method and Structure for the Buy-in

• Two part process
  • Stock purchase (equipment)
  • Income discounting (accounts receivable and goodwill)

Method and Structure for the Buy-in

• Tax considerations
  • Capital Gains vs. Ordinary Income
  • Financial affordability issue
Values Involved in the Buy-in

- The "big three"
  - "Hard assets" (equipment, other tangible assets)
  - Accounts receivable
  - Goodwill

"Hard Assets"

- Modified net book value
  - Eliminate assets no longer in use
  - Section 179 assets
  - Restate depreciation
    - Straight-line depreciation over 8 - 12 years
    - 20% floor

"Hard Assets"

- Modified net book value, continued
  - Capitalized (non-operating) leases
  - Exclude personal items (automobiles, artwork, etc.)
  - Possible appraisal of "major" ophthalmic equipment
"Hard Assets"

- Modified net book value
- Less debt and other liabilities
- Example

Other Values

- Inventories / Supplies
- Leasehold interests and improvements
- Contractual arrangements

Accounts Receivable

- Include associate's accounts receivable?
- As of when?
- How to value them?
- Example
Goodwill Value

- What is it? Does it exist?
- Date of valuation
- Include associate's revenue?
- Guidelines for ophthalmology

Co-ownership

- 51%/49%? 50/50?
  - Financial issues
  - Control issues
  - Psychological issues
- Equal ownership, with senior doctor protection
- What impact on compensation?

The Stock Purchase

- Equal stock at once?
  - "Hard assets" value only
  - Measure as of year-end / month-end
  - Spread payment over time with interest
    - Down payment
    - Interest rate
Senior Partner's Protection - Stock Option

- Trade-off for (early) equal ownership
- Limited time period
- Is it fair to the associate?
- Is it fair to the practice not to have it?
- Are there alternatives?

Income Discounting

Defining "net income"
- Salary and bonuses
- Retirement contributions
- Fringe benefits
- "Semi-personal" business expenses
- Practice profit or loss

Income Discounting

Defining "net income"
- Examples
Income Discounting

- Two ways to "discount"
  - Exact method
  - Inexact method
- How should the discount be reallocated among the other practice owners?
- Viability in a changing health care environment

### Inexact Method

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Examples
Pay-out Planning

• Planning ideally begins prior to the time of the first owner's departure
• Agreements should be entered into prior to the time of the first owner's departure
• Pay-out arrangements should be done in conjunction with an associate's buy-in

Pay-out Planning

• Remember, there were four things happening simultaneously in a buy-in
  • Buy-in
  • Governance / Decision Making
  • Income Division
  • Pay-out

Formal Valuation of Practice?

• Not strictly necessary
• Review financials
• Ball park values usually involved
• Evaluate financial feasibility
Method and Structure for the Pay-out

- Two part process
  - Stock repurchase / redemption (equipment)
  - "Separation Pay" / Deferred Compensation (accounts receivable and goodwill)

Method and Structure for the Pay-out

- Tax considerations
  - Capital Gains vs. Ordinary Income
  - Tax deductible or not
  - Financial affordability issue

Practice Valuation Upon Departure

- Same assets and valuation as for the buy-in
  - “Hard assets”
  - Accounts receivable
  - Goodwill
  - Other values
  - Reluctance of partners to recognize goodwill
Stock Repurchase / Redemption

- Payments over time with interest
  - Down payment
  - Minimum payments
  - Interest rate
- Tax treatment

"Separation Pay" / Deferred Compensation

- Deciding on the pay-out amount
  - Accounts receivable
  - Goodwill value of ongoing group

"Separation Pay" / Deferred Compensation

- Deciding on the pay-out amount
  - Year's "net income" principle
  - Example
  - Spread out over a number of years
  - Tax treatment and issues
Funding a Pay-out

- Use of insurance
  - Life
  - Disability
- Create corporate reserves?
- Funding from ongoing earning capacity
- Ongoing partners' personal guarantees?

Limitations to Protect Ongoing Group

- Reduction if compete / solicit patients
  - Logical necessity
  - How broadly to define the restrictive covenant?
  - Reduce all, or only the goodwill portion?
  - Recoup amounts previously paid?

Limitations to Protect Ongoing Group

- Reduction for short notice given for voluntary termination of employment
- Reduction for sick pay previously received
- Reduction for "bad behavior"
Limitations to Protect Ongoing Group

- Reduction if group’s income decreases
  - Philosophical question if proper
  - Should reduction extend the payments?
    - If so, how long of an extension?
    - Indefinitely, until paid?
  - Multiple pay-outs at the same time

Limitations to Protect Ongoing Group

- Reduction for post-separation benefits
  - Malpractice insurance
  - Health, disability, and life insurance
  - Other benefits

Limitations to Protect Ongoing Group

- Reduction for post-separation liabilities
  - Malpractice, tax, third party repayment obligations, etc.
  - Eliminate remaining "separation pay" / deferred compensation or attempt to recoup all
Miscellaneous Pay-out Issues

- Senior doctor's pay-out
  - Senior doctor's own pay-out, plus
  - Remainder of associate's buy-in

Miscellaneous Pay-out Issues

- Phase up of associate's entitlement to a pay-out
  - Phase up directly proportional as buy-in is completed?
  - Longer phase up?

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