Medical Group Management Update
October 1, 2000

Does your buy-sell agreement need a tune-up?

By Jeremy N. Miller, J.D.

One of the surest routes to a costly fight among the physician owners of a medical group is to not have in place an up-to-date, well-thought-out buy-sell agreement.

The purpose of an agreement is to provide for the orderly purchase by a medical corporation, partnership or limited liability company of the ownership interest of a physician owner who dies, becomes disabled, retires or withdraws from the group, voluntarily or involuntarily. At a minimum, a proper buy-sell agreement needs to address:

- triggering events;
- purchase price;
- disbursement;
- tax issues;
- restrictive covenants:
- review and amendment; and
- dispute resolution.

Triggering events

The buy-sell agreement needs to specify under what circumstances the group has the right or the obligation to repurchase a physician's ownership interest. Typical "triggering events" include an attempted sale of the physician's ownership interest to a third party; death; disability (which needs to be defined); loss of a physician's license; termination of employment; retirement; expulsion from the group; divorce and bankruptcy. Repurchase is generally mandatory in the event of a physicians' death, disability, or loss of license.

Purchase price

Physician owners should agree, in advance, on how much a departing physician will be paid for his or her ownership interest. Among the methods for determining the buy-out price are to:

- pay the departing physician the same amount as the physician paid to buy in to the group;
- pay an amount that is fixed by the owners each year;
- use a formula, such as "book value"; or
- hire an appraiser.

In determining a “fair” price, groups should bear in mind that in most cases, the remaining physician owners will have to make the payments. An exception would be if the group has purchased life or disability buy-out insurance.

Frequently, the group’s founders expect younger owners to fund a significant buy-out payment. However, insistence on an unrealistically high amount has been known to cause groups to split apart. This can occur if the younger owners conclude they will be better off financially if they leave rather than pay for the buy-out of the older physicians.

Physicians also should consider that medical practice values generally have declined in recent years. Therefore, if the group’s buy-sell agreement has not been modified in the last five to 10 years, it may include a buy-out price that is too high.

The trend appears to be toward more limited payments based upon the value of the group’s furniture, fixtures and equipment, and the physician’s share of accounts receivable, minus certain accounts payable and liabilities. Goodwill is included less frequently.

Disbursement

The buy-sell agreement needs to specify when the purchase price will be paid. If the price is nominal, it should be paid upon the physician’s departure.

If the buy-out amount is substantial, the group may want to provide that a portion, such as 20 percent, serve as a down payment, with the balance to be paid over a period of months or even years, with interest.

Because of the precarious state of many medical groups’ finances, some groups include a cap on total group revenues that can be used to make buy-out payments.

Tax issues

If the medical group is a corporation, it will not be able to deduct money paid to repurchase a physician’s stock. However, any gain the departing physician has on the sale of his or her stock may be taxed at lower capital gains rates.

If a portion of the buy-out payment represents the physician’s share of accounts receivable, then this may be more appropriately paid out through the physician’s employment agreement as deferred compensation. Deferred compensation payments, while generally deductible by the corporation, will be taxed as ordinary income to the physician.

Restrictive covenants

If the medical group expects the departing physician to be bound by a restrictive covenant, then it should be included in the buy-sell agreement. Restrictive covenants can take a number of forms.

For example, the departing physician might be prohibited, for a reasonable period of time, from practicing medicine within a certain number of miles of the group's offices. There also might be prohibitions against the disclosure or use of the group's confidential information, such as patient and price lists; and restrictions on soliciting the medical group's patients, patient referral sources and employees. The enforceability of restrictive covenants differs from state to state.

Review and amendment

The buy-sell agreement should be reviewed periodically to make sure that it still makes sense in light of the medical group's current circumstances, which may have changed considerably from when the agreement was drafted. If necessary, make amendments. Typically, buy-sell agreements provide for amendment only with the approval of all the physician owners. But groups may want to consider permitting amendment by a certain percentage, such as 75 percent.

Dispute resolution

Even with a well-prepared buy-sell agreement, disputes can arise. The most common areas of dispute are calculating the purchase price and restrictive covenants. Therefore, the buy-sell agreement should specify how disputes will be resolved, including alternatives to court, such as mediation and arbitration.

A carefully drafted buy-sell agreement is essential for any medical group's long term well-being. While the issues which need to be agreed upon can be difficult, it is well worth spending the time. Failure to do so almost inevitably will cost the medical group far more in the event of a dispute.

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