BETTER Buy-Sell AGREEMENTS

A CAREFULLY DRAFTED BUY-SELL agreement is essential for a medical group's long-term well-being. Here are seven key considerations.

BY JEREMY N. MILLER, JD

This is the first article in a two-part series examining key medical group contracts. The second article will focus on physician employment agreements.

Forget the Stark law and HIPAA. Perhaps the surest route to a long, nasty and expensive problem for your medical group is not to have a current, well-constructed buy-sell agreement.

A buy-sell agreement provides for the orderly purchase by the medical corporation or partnership of the stock or partnership 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 should address the following issues: triggering events; purchase price; payment of the purchase price; 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;
- Loss of a physician's license;
- Termination of employment;
- Retirement;
- Withdrawal from the group;
- Divorce; and
- Bankruptcy.

Repurchase is mandatory under California law in the event of a physician's death or loss of license. Repurchase in the event of divorce or bankruptcy might be limited to situations where the physician's ownership interest could otherwise be taken by a spouse or creditor.

Defining disability can be tricky. Typically, a physician is considered disabled if he or she cannot substantially perform his or her normal professional duties for the group for a specified number of consecutive or nonconsecutive days during a given time period. Disability should be determined by an independent physician selected by the group.

Purchase Price

It is crucial for the physician owners to agree, in advance, on how much a departing physician will be paid for his or her ownership interest. Among the methods for determining the buyout price are the following:

- Pay the departing physician the same amount he or she paid to buy into the group;
- Pay an amount that is fixed by the owners each year (which groups often fail to do);
- Use a formula such as "book value";
- Pay the departing physician his or her capital account; or
- Hire an appraiser to value the practice.

If book value will be used, the agreement should address whether all assets *and* liabilities will be taken into account. As discussed below, accounts receivable should generally be paid out pursuant to the physician's employment agreement. If an appraiser will determine the purchase price, the buy-sell agreement should indicate whether the practice's goodwill will be included, and how the appraiser will be selected and paid.

In determining a "fair" price, groups should bear in mind that in most cases, the remaining physician owners will have to make the payments. The smaller the group, the more burdensome this is likely to be. One way to reduce the financial burden in the event of a physician's death or disability is for the group to purchase life or disability buyout insurance. Not infrequently, the group's founders expect the younger owners to fund a significant buyout payment. However, insistence on an unrealistically high amount can cause younger owners to leave and split groups apart.

Further, groups should avoid setting the price so high that it encourages physicians to leave and cash out. Physicians should consider that medical practice values have generally declined in recent years. Therefore, if the group's buy-sell agreement has not been modified in the past five to 10 years, it may include a buy-out price that does not reflect the group's current value.

The trend appears to be toward more limited payments based on the value of the group's furniture, fixtures and equipment, and the physician's share of accounts receivable, minus certain accounts payable and liabilities. These days, goodwill is less frequently included. One reason is the recognition that a departing physician generally takes his goodwill and does not leave it with the group.

Payment of Purchase Price

The buy-sell agreement needs to specify when the purchase price will be paid. If the price is relatively nominal, then it should be paid immediately upon the purchase of the departing physician's ownership interest.

If the buyout amount is substantial, the group may want to state that a portion (e.g., 20 percent) be paid as a down payment with the balance paid over a period of months or even years, with interest.

Because of the precarious state of many medical groups' finances, groups should consider including a cap on total group revenues that can be used to make buyout 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.

On the other hand, if a portion of the buyout payment actually represents the physician's share of accounts receivable, then this money might be more appropriately paid 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. The Internal Revenue Service has adopted complicated new rules concerning nonqualified deferred compensation plans that must be considered when planning this type of deferred compensation.

Restrictive Covenants

If the medical group expects the departing physician to be bound by a restrictive covenant, then it should be written in the buy-sell agreement. Restrictive covenants include:

- Noncompete agreements stating that the departing physician will not practice medicine within a certain number of miles of the medical group's offices for a period of time;
- 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.

It is difficult, although not necessarily impossible, to enforce certain restrictive covenants in California. As a general rule, a noncompete agreement will not be enforceable unless the purchase price includes the goodwill value of the departing physician's ownership interest.

Review and Amendment

The buy-sell agreement should be reviewed periodically to ensure that it still makes sense in light of the medical group's current circumstances and current law, which may have changed considerably from when the buy-sell agreement was prepared. If necessary, amendments should be made. Unfortunately, many groups' buy-sell agreements provide for amendment only with the approval of all physician owners. But groups may want to consider permitting amendment by a lesser vote, e.g., 75 percent.

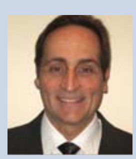
Also, owners should be aware that they may have a fiduciary duty to each other. For example, an amendment should not be adopted to unfairly lower the purchase price to be paid to a physician who is about to depart.

Dispute Resolution

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

The agreement should also state that even if the departed physician refuses to sign over his or her stock or partnership interest to the group because of a dispute over the purchase price, for example, the group can still terminate the physician's status as an owner without the physician's written consent. This can help avoid the situation where a departed physician is able to remain an owner by refusing to transfer his or her stock back to the group.

A carefully drafted buy-sell agreement is essential for a medical group's long-term well-being. In preparing the agreement, physicians should attempt to focus on what will be good for the group, rather than for them individually. While the issues that need to be agreed upon can be difficult to resolve, it is worth spending the time. Failure to do so almost inevitably costs the medical group far more in the event of a dispute. ■



Jeremy N. Miller, JD, is the founder of Miller Health Law Group in Los Angeles. Miller specializes in the representation of physicians for their healthcare and business law needs. He can be reached at 310/277-9003 or jnm@millerhealthlaw.com.