STRUCTURING PHYSICIAN SEVERANCE BUY-OUTS

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I. INTRODUCTION

This presentation examines the business and tax issues involved in structuring the buyout of a departing physician from a medical practice, whether from a partnership, limited liability company (LLC) or a professional corporation. As with so many other issues involving medical practices, each case is unique and there are few clear answers that exist that will apply in every buyout. This presentation is intended to raise the issues and give possible planning solutions.

The presentation will generally cover the following topics:

- Drafting buyout provisions of shareholder agreements or operating agreements to plan in advance for the departure of a physician.
- How to value the interest of a departing physician.
- Structuring and financing buyout payments.
- Structuring buyout in most tax advantageous manner.
- Non-compete and non-solicitation agreements.
- Regulatory concerns that may be implicated in buyout arrangements.

II. DRAFTING SHAREHOLDER AGREEMENTS AND OPERATING AGREEMENTS TO PLAN FOR THE DEPARTURE OF A PHYSICIAN

Because the departure of a physician can often be contentious, it is advisable for a medical practice and the physician/shareholder to agree at the start of the relationship upon various issues that will more than likely arise when the physician departs. The outline below discusses the more important issues at stake:
A. Restriction on Transfer of Shares in Professional Corporation

1. Shareholder agreements can provide restrictions on the ability of a physician/shareholder to sell his shares in the professional corporation to a nonshareholder (the same restrictions can apply in an operating agreement of a professional LLC or partnership). Such restrictions include a right of first refusal usually allowing other shareholders and/or the professional corporation to purchase the shares sought to be transferred at a stipulated price within a certain time period. In the event the shareholders or corporation do not exercise their rights of first refusal, the physician/shareholder is then free to sell his shares to a nonshareholder. The next section discusses methods to determine the value of the shares, which include:

   (1) an income approach, which uses estimated future cash flows and then imposes an appropriate discount to obtain a present value of the medical practice. This is the most common approach for valuing a medical practice;

   (2) a cost approach which values both the tangible and intangible assets of a practice;

   (3) a market approach which is a comparative analysis of amounts paid for similarly situated practices; and

   (4) formulaic approach in which the value is determined by a predetermined formula.

2. Shareholder agreements also can provide provisions if a dispute as to the valuation arises. Common language placed in such an agreement could be as follows:

   The actual purchase price under the method of valuation shall be determined by the corporation or by the certified public accountants who prepare the corporation’s income tax returns. In the event there is a dispute between the corporation and the selling shareholder as to the value of the shares of stock in the corporation, such dispute shall be resolved by arbitration whereby: the corporation and the selling shareholder shall be entitled to appoint one independent arbitrator each and these two shall appoint a third arbitrator, and the decision of the majority of such arbitrators shall be binding on the parties [Note: An alternative would be to average the arbitrator’s decisions as opposed to taking the majority decision].

3. Shareholder agreements should also provide for the treatment of stock upon the termination of employment of the physician (i.e., when the physician departs involuntarily either with or without cause). In such a case, the
shareholder agreement could require the departing physician to sell to the
corporation and also require the corporation to purchase from the departing
physician all of the stock at an agreed upon price (as determined above). In some
cases, the amount that a departing physician will be entitled to receive will be
discounted if he leaves to join another practice or he is terminated for cause.

B. Timing of Payments upon Sale of Shares by Departing
Physician to Other Shareholders or Corporation

Shareholder agreements usually provide what will be the schedule of
payments to a selling physician/shareholder. The agreement may provide a
threshold purchase price whereby an amount under such price would be payable
at the time of the sale and any amounts above such price would be payable in
installments over time. In most cases the agreement will provide that the initial
payment will be at minimum in an amount that is sufficient to cover the departing
physicians up front taxes as a result of the purchase. The shareholder agreement
should provide the rate of interest to be charged on the debt to the shareholder and
should set forth the manner in which the payments will be made (i.e., monthly,
quarterly, annually). The corporation or purchasing shareholders should also be
given the right to prepay the debt at any time without penalty. The shareholder
agreement may also provide that at the time of the sale of the shares of the
departing physician, if the shareholder is indebted to the corporation in any
amount, then a full offset for such indebtedness shall first be applied to reduce the
amount owing to the selling shareholder on the purchase price for the shares. One
common bone of contention is whether assets of the practice will secure the
installment obligation and/or whether the remaining physicians will guarantee the
debt.

C. Purchase of Insurance Policies on Departing Shareholder

Shareholder agreements generally provide that the departing physician/
shareholder is to obtain at his own expense professional liability insurance for all
periods after the sale of his stock and, depending upon the circumstances of his
departure, require him to purchase “tail” insurance. As for any life insurance
policies that may exist on the physician, one option is for the departing physician
to purchase from the corporation any life insurance on the physician owned by the
corporation for a price equal to the cash surrender value of the policies at the date
of the sale. One option available to the corporation could be that if it is
purchasing the stock of the departing shareholder, the corporation may at its
option purchase the stock by using the life insurance policies on the departing
physician at the insurance’s then cash value. A common provision in an
agreement is that each physician must agree to submit to an examination in order
for the practice to obtain life insurance and that the practice will maintain such
insurance.

D. Non-compete Covenant
Shareholder agreements should also provide a non-compete covenant in the event of departure. Nothing causes more animosity than if a departing physician goes to work for a cross-town competitor or if he uses the proceeds of his buyout to start a competing practice. Non-compete covenants are closely scrutinized by courts (see discussion below) and generally speaking such agreements must be reasonable in length of time and geographical scope. In order to avoid nullifying the entire agreement in the event any part of the restriction is deemed unreasonable, the non-compete covenant should provide that if a court nullifies part of the agreement then the restrictions are intended to and shall extend only for such period of time, in such area and with respect to such activity, as is determined by such court to be reasonable ("blue pencil" clause). Non-compete covenants against doctors are particularly difficult to enforce. We suggest adding a “liquidated damages” clause that provides that any physician in violation of the covenant not to compete shall immediately pay to the practice a certain sum of money. This amount can be withheld from any amounts owed to the physician pursuant to the shareholder’s agreement or operating agreement, as the case may be. Liquidated damage clauses are much easier to enforce than restrictions on a doctor’s right to practice.

E. Termination of Employment Agreement

1. Shareholder agreements should provide that upon the departure of the physician, any employment agreement should be terminated and that neither the corporation nor the departing physician shall have any obligations under the employment agreement except as specifically provided. Issues that arise include the payment of any salary to the departing physician, the collection and payment of any bills that remain outstanding at the time of termination, termination pay, and transfer of any assets or leases held in the physician’s name.

2. A typical provision regarding accounts receivable could provide that the corporation will be entitled to all fees and charges for all medical services rendered by the departing physician that have been collected prior to the termination date and the physician shall cooperate with the corporation as may be reasonably necessary in connection with the collection of such amounts. For fees and charges that are collected after the termination date, the shareholder agreement should provide whether the departing physician is entitled to any portion of such amounts or if the termination pay to the departing physician takes into account such receivables. If it is determined that the departing physician is to received the accounts receivables which are collected after the termination date, the shareholder agreement should allocate whether the physician receives 100% of such amounts or whether a reduced amount should be disbursed with the corporation retaining the balance to cover overhead expenses incurred.

3. The shareholder agreement might also provide that the corporation would provide support services to the departing physician for a limited time after
the termination date in order to collect the accounts receivables that remain outstanding after the departure of the physician.

4. The transfer of assets owned by the departing physician should also be covered in the shareholder agreement. For example, the agreement should provide that the departing physician should receive specific assets he owns, any interests in the corporation’s property, and even rental space. As previously mentioned, the agreement should also contain a provision as to who pays the “tail” for the departing physician.

F. Patient Records

The issue of patient records is an important issue that should be set forth in the shareholder agreement. An example would be for the departing physician to have the right and obligation to retain and maintain all medical records in accordance with applicable laws, rules and regulations and generally accepted professional standards in the event the physician’s patients continue to use the physician after the termination date. The corporation, however, should be granted access to such medical records in instances where the corporation is preparing for litigation, responding to regulatory inquiry or conducting a good faith audit pursuant to its compliance program.

G. Limit on Liability

The shareholder agreement should provide a section setting forth the limitations of liability by the corporation going forward after the departure. Sample language could include a provision that states that the practice does not assume any liabilities or obligations of the departing physician of any kind in connection with the departing physicians operations or practice beginning on or after the termination date including without limitation any obligation to make lease payments on specified equipment transferred to the departing physician. The agreement could also provide that the physician shall indemnify and hold harmless the corporation and any related or successor companies from an against any and all claims resulting directly or indirectly from the negligent, intentional or other acts of the departing physician from and after the termination date.

H. Confidentiality

In many cases, the corporation will want to ensure that the terms governing the departing physician remain confidential. To ensure that this is followed, the shareholder agreement should provide a clause that provides substantially as follows: "the physician agrees to keep the existence and terms of the shareholder agreement confidential and shall not, without the prior written consent of the corporation, disclose the terms of the agreement to any third party, with the exception of the physician’s attorney, financial advisor, or spouse, unless
required to do so by law after pursuing any available means of maintaining confidentiality."
I. Mandatory Withdrawal Provisions

It is also advisable to have a provision in the agreement that allows the practice to force out a physician at such time as his services are no longer desired by the practice. For example, the following list of activities would be deemed to be a voluntary withdrawal by a physician subjecting him to redemption by the practice at a full or reduced purchase price. A physician that is terminated “for cause” may receive, for example, only an amount equal to the accounts receivable generated by the withdrawing physician less his share of overhead plus his capital account:

1. Physician reaches age 70;

2. Physician’s license to practice medicine is revoked, suspended or restricted;

3. Physician’s medical staff privileges at the hospital where he has privileges, board certification or recertification, state or federal controlled substance registration or malpractice insurance, is revoked, withdrawn or restricted.

4. Physician’s is found guilty in any state or federal criminal proceeding (excluding minor traffic violations or misdemeanors that would not reasonably be expected to effect his performance of his medical practice, his obligation under the agreement or will reflect negatively on the practice).

5. If, as a result of any investigation or proceeding, whether administrative, civil or criminal, the physician is found liable for filing false health care claims, violating anti-kickback laws or engaging in other billing improprieties.

6. Physician has a dependency on or habitually uses or there is episodic abuse of, alcohol or any controlled substance (other than lawfully prescribed medication).

7. Physician engages in intentional or repeated unintentional, dishonesty in connection with the provision of medical services.

8. Voluntary or involuntary bankruptcy or insolvency proceedings are instituted by or against such physician.

9. Physician breaches any material provisions of the shareholder’s employment or operating agreement.
J. Characterization of Redemption Payments

The agreement should also include a provision setting forth whether any portion of the payments is deductible by the practice. In the case of a payment to withdrawing partner of a partnership or LLC, the agreement should set forth whether any portion of the payments are covered by Code § 736 (a) or 736 (b) (discussed later in the outline).

III. VALUING THE DEPARTING PHYSICIAN’S INTEREST IN THE PRACTICE

As previously mentioned, when a medical group was formed or when a physician is first brought into the medical group, it is advisable to set forth in advance through a shareholders’ or operating agreement the method for valuing the departing physician’s share of the practice. The buy-sell agreement affords an opportunity for the physicians to set the value to be received for each of the respective shares at a time when the physicians do not know who will be bought out, so that the parties are attempting to set a fair value on neutral terms. A buyout provision in the shareholders’ or co-ownership agreement may provide a formula for valuing the interest of a departing physician or may leave it up to an appraisal process. Additionally, the provisions may provide different formulas for a departing physician that is retiring versus relocating and/or competing.

A. Typical Valuation Provisions

1. Fixed Valuation of Contributed Practice Assets at the Time of Contribution

The shareholder or operating agreement can specify a fixed value for each shareholder’s capital contribution to the medical group based on an appraisal or agreed value at the time of contribution and then provide that if a physician departs prior to dissolution of the entity he is only entitled to the value of his capital contribution back plus, possibly, a share of receivables outstanding at the time of his departure.

**Pros**
The value is determined at the time the corporation is being formed, and negotiation tend to be fair and friendly.

**Cons**
The appraisal costs will be at the time the practice is being formed, thus the shareholders may need to invest more in order for the corporation to cover this expense.

This type of provision leads to unequal contributions, and voting rights tend to be based on each shareholder’s percentage of capital contribution. In order for the voting rights of the shareholders to
be equal, other mechanisms will be needed. It also doesn’t take into account any growth in the value of the practice.

This method tends to favor the physician who has been in practice for a longer period of time. Whereas, a physician who has just started practicing would prefer valuation at the time in which he or she withdraws so that the valuation would take into account any growth the practice may have experienced.

An issue arises in the context of an acquisition or merger of the medical group, since the buy out value may be far below that which will be paid. The agreement should likely include a provision that the departing physician is entitled to his or her share of the sales proceeds if the practice is sold within 6 months of the physician’s departure.

2. Specified Fixed Price of the Practice Updated Annually

Shareholders' or operating agreements will sometimes require that the value of the practice be stipulated to at the time the shareholder’s agreement is initially executed. Each year the stockholders, members, board of directors or a committee meet and review the previously stipulated price. The stockholders then attempt to agree to modify the stipulated price to reflect what they believe to be the then current fair market value of the practice usually upon a recommendation by the practice's accountant shortly after the financial statements are completed for the fiscal year. We recommend that the shareholder’s agreement contain a formula to guide the accountant in determining the annual value. Generally a departing physician is paid the stipulated price if he or she leaves within 12 to 18 months of the date of the stipulation. If the physicians cannot agree to an adjustment in the stipulated price for a fiscal year, the agreement price, as most recently adjusted, can be increased, for example, by a factor equal to the short-term Applicable Federal Rate or by undistributed earnings for the year. If the group cannot reach agreement as to the stipulated price for two consecutive fiscal years then in some agreements an appraisal will be required.

**Pros**

Using a fixed price is simple and certain. It allows the physicians a chance to determine the value of the practice in advance rather than leave it to chance when a physician withdraws. Less chance for controversy. Helps in retirement planning.

**Cons**

A fixed price may not adequately reflect the increase or decrease in value after the agreement is initially executed. Valuation is such a difficult issue that it is easy for the physicians to procrastinate and permit the purchase price to remain the same from year to year. This problem may be partially resolved by stating that the agreed
price will be increased or decrease by the practice's increase or decrease in earnings.

3. Valuation of Practice at the Time of Termination, Retirement or Death

The shareholder agreement can specify that the practice assets will be valued each time a physician departs from the medical group. This valuation can be based on a predetermined formula based on earnings, receipts, receivables, etc, or can be left to an independent appraisal.

(a) Formulaic Approach

Set forth below are a sample of formulas that are typically used in shareholder or operating agreements.

i) Book Value

The book value of the practice is usually determined by the independent certified public accountant regularly employed by the practice as of the last fiscal year preceding the termination of employment with the calculation binding on both parties. The book value of the shares of the departing physician (the “Offered Stocks”) is usually determined in accordance with the regular financial statements prepared by the practice and in accordance with generally accepted accounting principles consistently applied.

In making this determination, book value is usually adjusted to reflect:

♦ An increase to the face amount in the value of any life insurance, of which the practice is the beneficiary, on the life of the departing physician whose shares of the practice are being purchased on account of his or her death;

♦ An increase in the value of any tangible assets with a useful life in excess of five (5) years to their fair market value; and

♦ Sometimes there will be allowed a reasonable adjustment to reflect the fair market value of any good will of the practice as determined by the CPA.

Pros This method is fairly simple to apply, and can be done at minimal cost. If several major assets have appreciated substantially, the agreement could provide that the actual value of those specified assets would be determined by appraisal and used for the valuation determination in lieu of the book value of those assets.
**Cons** Book value, often fails to reflect accurate value because it ignores the practice's earning potential. Furthermore, the book value figure generally does not even reflect true asset value since assets are usually carried on the books at original cost less depreciation, which may be considerably more or less than actual value or cost of replacements.

ii) **Net income**

Although easy to administer the net income of a practice is not a reliable indicator of the medical practice value. It is a factor of physicians’ overhead, including salaries for staff, supplies, and hours worked. If an examination of a practice reveals the practice is netting only 30% when similar practices in that specialty generally net 45% then this would suggest that the practice is not as successful as other similar practices in the area. Net income may also be negatively affected by physicians personal and estate planning needs.

iii) **Capitalization of Earnings**

The value of the shares of the Offered Stock of a departing physician could be set at a multiple (“capitalization factor”) of either weighted or unweighted average of the practices net earnings based on the three to five most recently ended fiscal years. Generally neither interest, taxes, depreciation nor other non cash flow items are considered part of the operational results of running the medical practice. Therefore, the standard normally considered is the earnings before interest and taxes (“EBIT”).

In making this determination, earnings are usually adjusted to reflect:

- No deemed earnings on account of the receipt of any life insurance on the life of a physician whose shares of the practice are being or have been purchased on account of his or her death;

- Calculation of depreciation on the straight-line method;

- The elimination of any past service pension cost charges; and

- The elimination of any amortization of goodwill or other intangibles.

- Sometimes physician-owners salaries are added back to earnings and a deduction is taken for what would be the salary paid to a non-owner physician.

The capitalization factor will vary from one type of practice to another.
Pros  Again, this method is fairly simple to apply, as long as the capitalization rate can be fairly determined. There is also less chance for dispute since the value is based on an easily verifiable formula.

Cons  Capitalization of earnings may yield unreasonable values for a closely held medical practice because expenses, such as physician salaries and payment of personal expenses, are often determined for personal tax planning purposes rather than business needs of the practice.

iv) Multiple of Receivables either of the Practice as a whole or the Receivables Generated by the Departing Physician

It is not unusual to see medical practices valued at a multiple of a practice's average billings for the prior fiscal year. This method does not, however, take into account the fluctuation between different practices of generating those bills. Should consider discounting receivable by a factor that represents cost of overhead.

Pros  Most advisers say that buyer will base a decision to buy a medical practice mainly on gross income, on the theory that earnings will continue at this level in the future. The rule of thumb is that the higher the gross income, the higher the sales price. Avoids the issue of payment of personal expenses and high salaries of owner-physicians. Usually much less expensive than if an independent appraisal is required.

Cons  Sometimes use of a formula to value a practice may result in an inequitable purchase price. For example, basing the purchase price on a multiple of billings could result in a valuation far in excess of true value if the practice has a high cost of doing business as compared to the norm.

v) Formula utilizing several different factors

In some circumstances, the agreement may provide for a formula that utilizes two or more of the formulas discussed above. For example, the formula could provide that 60% weight be given to earnings factor, 30% to book value factor and 10% to capitalization of earnings factor.
(b) **Purchase Price Based on Future Earnings**

Another possible valuation formula would be to utilize installment payments as all or part of the purchase price, that are at least partly based on future practice earnings in the year that each payment is made.

**Pros** Eliminates some of the uncertainty inherent in valuing a medical practice since a portion of purchase price will be based on actual earnings.

**Cons** Allows departing physician to share in future growth.

(c) **Independent Third Party Appraisals**

Another alternative is to set forth in the agreement that the practice will be valued by appraisal of the effective date of withdrawal of a physician. Although relying upon an appraisal to be made at the time the purchase is triggered under the shareholders or operating agreement is an easy alternative at the drafting stage, it may present practical problems later because of the expense involved, the requirement of drawing third parties into the valuation, and the difficulty of appraising medical practices.

There are a number of variations to choosing a third party appraiser, a few of which are set forth below.

i) The practice appoints a qualified appraiser and his or her determination of the fair market value is binding on all parties

ii) The departing physician and the practice each appoint, at his, her, or its own expense, a qualified appraiser. These two appraisers appoint a third appraiser and his or her determination of the fair market value is binding on all parties. If the two appraisers cannot agree on a third appraiser, an appraiser is chosen by the American Arbitration Association.

iii) The departing physician and the practice each appoint, at his, her, or its own expense, a qualified appraiser. These two appraisers establish the fair market value of the Offered Stock in a single written opinion agreed to by both of them. If the two appraisers cannot agree on the fair market value, the two appointed appraisers together appoint a third qualified appraiser whose sole written opinion will establish the fair market value of the Offered Stock.

iv) The departing physician and the practice each appoint, at his, her, or its own expense, a qualified appraiser. These two appraisers establish the fair market value of the Offered Stock in separate written
reports. If the two values differ by more than 10%, a third appraiser is chosen by the first two and his or her appraisal is averaged with one of the first two appraisers that is the closest in value.

No matter which method is chosen, the agreement should give direction to the appraiser as to what to consider in the report. For example, should goodwill be included, should there be any discounts for minority interests or lack of marketability, should owner salaries be discounted to salaries of non-owner physicians. In addition, each of the parties should be given an opportunity to select an appraiser only within a specified period time. If one is not appointed, one will be selected on behalf of that party by the practice or, in the alternative, the purchase price will be based on only the first party’s appraisal. Otherwise, one party may simply refuse to appoint an appraiser in order to disrupt the buy out process.

**Pros**
Reduces the risk that a formula will result in an inequitable valuation. Avoids use of possibly objectionable formula and leaves valuation to an independent party.

**Cons**
Increases dramatically the cost of the buyout, particularly if three appraisals are required. Also increases the time needed for the buyout since appraisers usually require extensive periods of time to complete the appraisals.

4. Methods of Valuing a Medical Practice for Departing Physician if No Formula

If at the time of formation, the medical group overlooked the inclusion of a buyout formula for a departing physician, then unless the parties can come to agreement, an appraisal will be required to determine the value of the departing physician.

Listed below are various approaches to determining fair market value of a medical practice.

(a) **Income Approach (or Discounted Cash Flow Approach)**

The Income Approach uses estimated future cash flows, which are then discounted using an appropriate discount rate of return to obtain the present value of the practice. The discount rate is a function of the perceived risk of the investment and the current capital cost. Since assumptions for future cash flow form the foundation of this method, projected income statements and balance sheets will be necessary to derive estimates to future cash flows.
Pros Traditionally, a popular and common approach to valuing a practice. It may be the appropriate approach for a mature practice that has demonstrated stable cash flows.

Cons The estimate of the future cash flow is based on the historical analysis of the practice. As a result, this approach has not been favored in recent years due to the rapid changes occurring throughout the healthcare industry, as well as government regulations.

(b) Cost Approach (Adjusted Book Value Approach, Excess Earnings/Asset Accumulation Approach)

The Cost Approach is a determination of the cost of replicating the assets of the practice. The determination includes the valuation of both tangible and intangible assets.

The tangible assets valuation takes into consideration the age and consideration of the assets, thus the value will be different than the value on the financial statements of the practice.

The intangible assets can be valued using either the Excess Earnings Method or the Weighted Earnings Method. The Excess Earning Method capitalizes prior years’ net income at a rate comparable (or higher) than that being currently paid on U.S. Government related bonds. The Weighted Earnings Method uses patterns of expenses that are adjusted by multiplying it to a factor, where the factor represents the item’s importance relative to the other items. The weighted average is then calculated by summing the individual results and dividing that sum by the sum of the weights.

Pros Value under the cost approach is usually easier to determine and more exact than under the Market Approach or the Income Approach because less assumptions must be made.

Cons In appraising a medical practice, replacement cost is not usually a valid method, since assets appreciate at different rates (some faster than others). This is especially true when the assets are old and the cost of replacing them would be considerably greater than using current dollars.

“Goodwill” is an intangible asset that generates disagreement between the departing physician and the medical group as its determination is highly subjective. Goodwill is often the “kitchen sink” of the intangible assets. It can be that value derived from favorable location or favorable leasehold; the medical practice’s going concern value; the use of seller’s name; patient lists; patient care contracts; employee contracts or credit reports. Covenants not to compete are
also lumped into the goodwill category. A medical practice where all its physicians have executed such agreement has more value to a potential buyer of that practice than another medical practice that has not restricted its physicians from competing. Goodwill is also referred to as the premium paid that cannot be set-off against a tangible asset. To add to the difficulty in valuing goodwill, goodwill is likely to make up the largest assets of a medical practice.

The medical care business has two types of goodwill: “professional goodwill” and “practice goodwill.” Professional goodwill is the goodwill that is attributable to the physician. Practice goodwill is the goodwill that is attributable to the practice as a whole.

**Physician Goodwill**
- Reputation
- Patient Records (unless Employment Agreement states otherwise)
- Patient List

**Practice Goodwill**
- Location of the Practice
- Amount of Competition
- Financial Condition of the Practice (potential earning capacity)
- Medical Specialty
- Referral Sources
- Practice Efficiencies (Office staff, computer systems)
- Hours Worked
- Patient Records
- Collection Ratio
- Ease of Transition

Employment Agreements or Restrictive Covenants may guide goodwill tax consequences. The tax treatment of goodwill depends on the threshold question is “Is the goodwill personal to the physician or to the medical group?” To answer this question, the courts may look to the existence of an employment agreement or restrictive covenants.

One role of the physician is to build and establish personal relationships with his or her patients. A physician that succeeds in that endeavor is likely to have his or her patients follow him or her to another location. This goodwill (i.e., the personal relationship with the patients) may be viewed as property of the physician or as property of the medical group.
The Tax Court has not based its decision on any one factor in making its determination concerning how goodwill will be allocated. The Tax Court will likely analyze the following:

- Is the medical group highly dependent on the services of the departing physician?
- Does an employment agreement or restrictive covenant exist between the departing physician and the medical group?

Without an employment agreement or restrictive covenant in place, the distribution of goodwill may viewed as property of the physician, not the corporation. See *Martin Ice Cream Co. v. Comm’r*, 110 T.C. 189 (1998); *Norwalk v. Comm’r*, 76 T.C.M. (CCH) 209 (1998).

(c) Market Approach

The Market Approach is a comparative analysis of prices actually paid for similar practices. To calculate accurately a medical practice’s value using the market approach, the appraiser should consider appropriate premiums and discounts. Determining a majority equity interest in the physician practice includes consideration of such premium to reflect the control that the practice has, and that which the physician in control has over the affairs of a practice. In the valuation of a minority interests in closely held stock, considerations for discounts for minority interest and lack of marketability are similarly essential

*Pros* There are many organizations (e.g. Goodwill Registry, Institute of Business Appraisers Inc.) that accumulate data concerning the prices paid for practices.

*Cons* The practice that is being valued may be highly specialized, or in an area for which there is limited comparison data available. Additionally, the approach is highly subjective due to the appraisers definition of “comparable”, as well as determining the applicable control premiums or discounts (for minority interests or lack of marketability)

IV. FINANCING OPTIONS FOR A BUYOUT EVENT

Typically, the full payment in available funds of the buyout amount to a withdrawing partner would have a deleterious effect on the medical practice since it would likely reduce working capital to unhealthy limits. Thus, the consideration for the withdrawing partners interest in the medical practice usually includes receipt of installment note whether from the medical practice itself or from the other physicians. Issues that must be resolved are: i) what is the typical
length of an installment note, ii) will the debt be secured by assets of the medical practice, iii) will the debt be guaranteed by the remaining physicians, iv) what amount of interest will be assessed on the debt, v) will there be a right of set-off for a breach of the buyout agreement, vi) will there be a right of acceleration under certain circumstances, and vii) what role will life insurance have on the buyout of a physician.

A. Consideration for a Buyout

Generally, the shareholders agreement or LLC operating agreement will set forth in advance whether the payments to the departing physician will be paid fully in cash or partially with an installment note. We typically draft our agreements to give the medical practice the option of full payment in cash or partially in cash with the remaining amount in an installment note. The departing physician will usually want the agreement to provide that the down payment will be no less than the amount that he or she is required to pay in tax in the year of departure.

B. Terms of Installment Note

We generally do not draft installment notes to go beyond five years. More typically, the term of installment note will be from 24 months to 36 months with an interest rate typically set at prime.

C. Security for Installment Note

An attorney representing the departing physician will invariably request that either or both the medical practice and the remaining physicians guarantee the installment note. Typically, the practice will give a security interest in its assets but such security interest will be subordinated to debt and borrowings incurred by the practice in the ordinary course of business. In most instances, the remaining physicians will not agree to guarantee the debt of the practice to the departing physician. In very rare instances, the departing physician will require that the practice obtain a letter of credit or place securities in an escrow account.

D. Right of Set Off

The most painful thing that can happen to a medical practice is to have a departing physician use the proceeds of the buyout to fund the start-up of a competing practice in the same area. Often, the buyout agreement will provide that the remaining payments on the installment note will be forfeited or reduced if the departing physician starts or joins a competing practice in the area. This also may be one way of stretching out the non-compete agreement, which is typically only good for two years. The agreement should also provide rights of set-off in the event that any claims are made against the practice that are not covered by insurance.
E. Right of Acceleration

In some buyout agreements, the installment note accelerates in the event that the practice is sold or one or more of the remaining physicians leave the practice.

F. Right to Liquidate Practice in Lieu of Paying the Buyout Amount

Sometimes it is helpful to provide in the agreement (or in the shareholders or operating agreement) that the practice has the option to liquidate (or sell) the practice in lieu of paying the previously agree upon purchase price or remainder of installment notes.

G. Payout Based on Future Earnings

In some agreements, the payment schedule on the installment note will be tied to available cash flow of the practice. For example, the agreement may provide that payment in any year will not exceed five percent of the practice’s gross receipts. In the event that this amount is not adequate to pay the annual installment to the withdrawing partner it will be paid in the next year subject to the same limitations.

H. Insurance

A typical agreement will provide that the down payment to a deceased or disabled physician will be no less than the proceeds of any insurance received by the practice or the remaining physicians. Some agreements provide that all of the insurance will be paid to the deceased or disabled physician notwithstanding that the insurance is in excess of the previously agreed upon purchase price but many times the practice will keep the excess of the insurance proceeds over the purchase price in order to help it locate a replacement physician.

I. Deferred Compensation

In lieu of installment note, as partial payment for the withdrawing physicians interest in the practice, which in many cases is not deductible to the practice, a portion of the payments can be treated as deferred compensation, which will be deductible to the practice but taxable at ordinary income rates to the withdrawing physician. The withdrawing physician may require use of a rabbi trust to hold the deferred funds. In a rabbi trust transaction, the practice sets aside the deferred amount but such funds are not protected from general creditors.
V. STRUCTURING BUYOUT IN MOST TAX ADVANTAGEOUS MANNER

Tax planning opportunities still exist for liquidation or termination of a physician's interest in a medical practice. The tax consequences of the buyout will depend greatly on the manner in which the buyout is structured and whether the departing physician is a shareholder in a professional corporation or a partner (or member) in a medical partnership or LLC. Below is a brief discussion of some of the common tax issues that arise in physician buyouts.

A. Sale to Other Shareholders or Corporate Redemption

1. Tax Consequences of sale to other shareholders (“cross purchase”)
   a. Agreement may provide that departing shareholder/physician would sell shares directly to other shareholder/physicians and not to corporation.
   b. Under cross-purchase agreements, amounts come from shareholders and not from corporate assets (including cash). Problem may arise as to how to finance purchase of stock.
   c. Selling shareholder/physician generally will recognize capital gain from sale of corporate stock (less risk of amount treated as compensation for services as discussed below).
   d. Buying shareholders get stepped-up basis in acquired shares.
   e. Other shareholders must use the after-tax proceeds to purchase stock of departing physician.
   f. Issues as to whether remaining shareholders have to provide security for deferred payments. Also issue as to whether practice can guarantee deferred payment since it receives no consideration.
   g. May be in issue as to whether remaining shareholders can enforce a covenant not to compete with departing shareholder.

2. Tax Consequences of Stock Redemption
   a. Payments come directly from corporation. Issue of whether corporation has sufficient cash flow. Deferred payments will be an outstanding liability on books of corporation.
b. IRS may not respect structure of transaction. Payments could be disguised payments for services rendered which would be ordinary income to shareholder/physician and deductible to corporation. Redemption would be capital gain to shareholder/physician and nondeductible to corporation (see discussion below). Will likely cause phantom income to corporation since corporation will be taxable on the receivables collected in order to pay for the redemption.

c. Remaining shareholder’s do not get step-up in basis of stock.

d. Departing shareholder may require a security interest in assets of corporation if deferred sale. May also require guarantees from remaining shareholders.

B. Tax Consequences of Redemption

1. Complete redemption.

   a. Section 302 provides that redemption will be treated as a distribution in exchange of stock thus entitling departing shareholder/physician capital gain treatment.

   b. Generally, where departing shareholder/physician’s entire stock is repurchased by corporation, such repurchase will constitute a redemption. Will be treated as termination of shareholder’s interest in corporation.

   c. Problem may arise if there is redemption, however, where family member is also a shareholder (spousal or parent/child is in practice) and remains as a shareholder with corporation following departure of the withdrawing physician. In that case, attribution rules apply and, unless the waiver of attribution rules set forth below apply, the departing shareholder/physician is still treated as a shareholder, thus there is no termination of a shareholder interest.

2. Waiver of Attribution Rules.

   a. Attribution rules do not apply if following three conditions are met:

   i) immediately after the distribution, the departing shareholder/physician has no interest in the
corporation (including an interest as an officer, director, or employee) other than an interest as a creditor;

ii) the departing shareholder/physician does not acquire any such interest in the corporation (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution; and

iii) the departing shareholder/physician files an agreement notifying the IRS of the redemption and agrees to notify the IRS of any acquisition of an interest in the corporation during the applicable period.

C. Will the IRS recharacterize payments for physician’s stock as deferred compensation

1. Deduction vs. Capital Expense

a. Payment for the acquisition of the departing shareholder/physician's stock will be taxed as a capital gain to the selling shareholder and is a nondeductible capital expense to the corporation for the acquisition of its stock.

b. Conversely, payments for services rendered or for an agreement not to compete will be taxed as ordinary income to the shareholder and is a deductible expense to the corporation. In addition, a practice may want to structure some of the payout to the departing shareholder as a payment for the noncompete in order to justify the provision in the agreement that the departing shareholder will forfeit some of his redemption payments if he does go to a competing practice.

c. Depending on the circumstances in each case, the parties may structure the buyout to accomplish the particular tax objective. For example, the payout could be structured partially as deferred compensation in order to provide the practice with a tax deduction. But the IRS is not bound by the parties’ structure where the form does not reflect the substance of the transaction.

d. Determining whether payments to a departing shareholder/physician constitute payments for stock or payments for services rendered or a payment not to compete is a factual question and there is no bright line rule.
2. **Illustrative cases**


   i. **Facts.** Radiologist in a three physician medical corporate practice agreed to leave the corporation. The parties agreed that the corporation would redeem the departing physician’s stock at book value. Realizing that amounts paid to the departing physician would not be a deductible expenses, the corporation then entered into a deferred compensation agreement with the departing physician in which the corporation retained the departing physician to perform unspecified advisory and consultative services on a part time basis at the direction of the Corporation’s board of directors. The deferred compensation agreement provided for a payout of a specified amount over the course of five years and was conditioned on the departing physician not practicing in an area that would be in competition with the corporation. The compensation agreement also provided that the payments were to continue even if the physician died (the payments in that case were to be paid to the physician’s wife).

   ii. **Issue.** Whether as alleged by the IRS the payments were in substance disguised payments to acquire the stock of the departing physician (which were not deductible to the corporation) and not as contended by the corporation deductible payments for services rendered.

   iii. **Holding.** Tax Court held that the payments were deductible compensation payments, notwithstanding fact that such payments were to continue even if physician died during the term of the agreement. Tax Court found that agreement was reached during arms’ length agreement and had independent significance. Tax Court found that even though the departing physician did not render consulting services to corporation, it was reasonable that the other physicians considered it necessary to have the departing physician available for consultation as his experience and personal contacts were important. Tax Court also found value in covenant not to compete. Tax Court rejected IRS argument that amount paid in excess of book value represented acquisition of goodwill, finding that corporation itself did not have earning capacity ordinarily associated with goodwill.

i. **Facts.** Four physicians were shareholders in a professional service corporation. One of the shareholders/physicians departed and he transferred all his stock to the corporation. In return, he received $40,000, which was calculated by considering a discounted value of the corporation’s accounts receivable. Agreement provided that $1,000 of payout constituted redemption of stock and $39,000 constituted a deductible salary expense for the corporation.

ii. **Issue.** Whether amount paid to departing shareholder was a deductible compensation expense or a nondeductible capital expenses to reacquire corporate stock.

iii. **Holding.** The entire amount was in redemption of corporate stock. Tax Court noted that account receivable were assets of corporation, not physician, and thus the payment represented the departing shareholder’s value in the corporation. No evidence in the record that payments were for services rendered. Tax Court also unwilling to believe that value of corporate stock was worthless given the accounts receivable asset.

D. **Redemption of a Partnership (or LLC) Interest of a Departing Partner**

1. Subchapter K of the Internal Revenue Code has historically afforded considerable flexibility in determining federal income tax consequences of the retirement or withdrawal of a partner from a partnership. In general, the departure of a partner can be structured either as a purchase of retiring partners interest by the remaining partners or as a liquidation of the partners interest in the partnership. Although these two transactions are essentially similar in economic consequences, they have been governed by two separate sets of the provisions in subchapter K, often resulting in significantly different tax consequences. The sale of a partner’s interest is governed primarily by sections 741 and 751 (a), whereas primarily section 736 govern a liquidation of a partner’s interest by the partnership.

2. Under section 741 and 751, the sale of a partnership interest generates capital gain or loss to the selling partner, except to the extent that he or she is being compensated for an interest in certain ordinary income items of the partnership, namely, its unrealized receivables and substantially appreciated inventory. Payments to the departing physician are generally not deductible to the partnership and therefore creates phantom income to the remaining partners.
3. Under section 736, the liquidation of a partnership interest by partnership could result in significant immediate tax benefits to the remaining partners. Under 736(a), certain payments for a retiring or withdrawing partner’s share of the partnership's unstated goodwill and unrealized receivables would give rise to an immediate deduction for the remaining partners and usually results in ordinary income to the retiring partner. Payments for the partner’s share of other partnership property would be treated under section 736 (b) as a distribution from the partnership to partner, resulting in no deduction for the remaining partners and, the most part, generating capital gain for the retiring partner.

4. Tax consequences to Selling Partner Under Section 741 and 751.

i) The selling partner will realizing recognize gain to the extent that his or her amount realized exceeds the adjusted basis of his or her partnership interest. Such gain will be treated as capital gain or loss, except as otherwise provided by sections 751.

ii) Under section 751, if the partnership has unrealized receivables, the partner who sells a partial interest will be treated as if he or she directly sold his or her proportionate interest in such receivables, resulting in ordinary income treatment. For purposes of section 751, the term unrealized receivables is defined as including, to the extent not previously includable in the partnership's income, any rights to payments for goods delivered or to be delivered or services rendered or to be rendered. Thus, a cash method partnership's outstanding accounts receivable constitute unrealized receivables. (The term no longer includes other ordinary income items, such as unrealized depreciation recapture inherent in the partnership property, as such items are now considered as relating to the property).

iii) To determine the amount treated as ordinary income, the selling partner must allocate a portion of the basis of his or her partnership interest to the unrealized receivables. This is done by determining the basis that the departing partner would have had in such receivables if he or she had received such receivables from the partnership in a current distribution.

5. Liquidation of a Partner's Interest Under § 736

a. Section 736 has divided partnership payments to a withdrawing partner into two categories.

i) Payments for the partners’ interest in partnership property are treated under 736(b)(1) as a liquidating distribution. Thus, except for unrealized receivables, gain or loss on the distribution of money in liquidation of a partner's interest results in capital gain or loss. The
remaining partners cannot deduct these payments since they represent either a distribution or a purchase of a withdrawing partner's capital interest in the partnership.

ii) Payments for the withdrawing partners share of unrealized receivables of the partnership cannot be treated as payments for a partner’s interest in partnership property. Instead, such payments fall within section 736(a), and are considered either a distributive share of the partnership income or as guaranteed payments. These payments usually constitute ordinary income to withdrawing partner and result in a deduction to the partnership.

iii) The amount paid for unstated goodwill is not treated as paid in exchange for partnership assets thus, the payments made by the partnership for goodwill in excess of the partnership's basis in the goodwill are treated as either a distributive share of partnership income or as a guaranteed payment. Generally, the evaluation placed on goodwill by an arm's-length agreement of the partners, with specific amount determined by formula is regarded as correct.

6. Payments deemed not made in exchange for the withdrawing partner's interest in partnership property are divided into two categories:

   i) Payments determined with regard to partnership income are treated as a partner's share of partnership income and

   ii) payments that are not determined with regard to partnership income are treated as guaranteed payments.

7. Treating amount paid a retiring partner as a distributive share of partnership income or as guaranteed payments is advantageous to the remaining partners since the payments reduce partnership income. Payments to a withdrawing partner however are treated as ordinary income pursuant to self-employment tax unless they meet certain requirements for exemption.

8. A partnership and the withdrawing partner can agree to the allocation of payments among the various types of categories. The partnership agreement or buyout agreement could provide, for instance, that payments to the extent of the withdrawing partner's capital account will be treated as payments for his share of partnership property and all additional payments will be treated as his share of accounts receivable and unstated goodwill. Since the departing partner will be giving up capital gain on the portion allocable to the account receivables and unstated goodwill, this is usually a highly contested provision unless it was included in the original partnership agreement.
9. In Miller v. Comm (1967, CA5), 19 AFTR2d 1107, a retiring partner was held to the terms of the allocation made by himself and his partners, allocating only a specific portion of the payments he was to receive to his partnership interest with the result that the remainder of the payments were treated as a distributive share of partnership income or guaranteed payment. The buyout agreement had been negotiated at arm’s-length. Since the retiring partner knew the facts and had adequate tax advice, the court held that he could not now complain that he failed to get his partners to put a higher value on the assets.

10. The cost of acquiring a withdrawing partner’s partnership interest may not be amortized under section 197 even if a portion of the purchase price is allocable to goodwill. If another person purchases the withdrawing partner’s partnership interest, such person will be entitled to amortize section 197 intangibles only if a section 754 election is in place. Goodwill is considered a section 197 intangible.

11. If the partnership makes a section 754 election, it would adjust the basis of its property under 734 (b) in connection with transfers of partnership interests. If a partnership interest is transferred while a section 754 election is in effect, the partnership must increase the basis of its property by the excess of the transferee’s basis in his partnership interest over his proportionate share of the basis of the partnership’s property.

VI. NON-COMPETE RESTRICTIVE COVENANTS

One of the most controversial issues faced by practice in dealing with a departing physician is how to stop the physician from taking patients with him to a competing practice. The attorney for the practice will have to research state law to determine whether or not covenants not to compete are binding in that state. The general common-law rule is that covenants not to compete will be upheld only if it is not against public policy to restrict the physician from providing medical services in that area. You have to show that there are enough competing physicians in the area to make up for the slack. In some states, however, the courts will uphold a covenant not to compete if the physician has been compensated for such agreement.

Even if you have doubts that a covenant not to compete will be upheld, it still may be a good idea to include such a restriction in the agreement (other than in states in which restrictive covenants are prohibited), because it may give a competing practice second thoughts about hiring the departing physician if it believes they face a lawsuit resulting from its hiring of that physician.

An effective package of restrictive covenants includes three kinds of restrictions: non-compete provisions, non-solicitation provisions, and confidentiality provisions. The non-compete agreements are, by far, the most
common form of restrictive covenants. It is important that these restrictive covenants be put in place prior to the departure of any physician so as to avoid the appearance of selective enforcement or preferential treatment.

The rule of thumb for restrictive covenants is that they must be given in connection with another contract. For example, the restrictive covenant would be ancillary to the buyout agreement or severance package.

A. Non-compete Agreements

A covenant not to compete is a contractual provision that seeks to prevent a physician from engaging in competitive activity that would damage the group’s business. It helps medical groups protect themselves against a threat of a physician departing with a host of patients that he or she acquired through the group’s visibility. Most courts are willing to enforce provisions that are reasonable and fairly negotiated between parties.

Factors to consider include:

**Time**

The covenant should last no longer than the likely lifespan of the special connections gained from employment. One to two years is generally recommended.

**Area**

The restricted area must truly reflect the medical group's market penetration. Restrictions in the form of a circle establishing the group’s territory risk being thrown out in court as they may include areas in which the group does not enjoy significant penetration. It is fairer and safer to plot the practice’s market area using patients’ zip codes.

**Hospital privileges**

Denying access to a key hospital effectively eliminates physician’s ability to stay in the area. Such provision runs some risk that a judge will find it an unfair penalty and strike the entire non-compete clause.

**Scope of Service**

Restricting the scope of services in the non-compete clause must be reasonable. A court may find it unfair to prevent the physician from staying in the area and practicing outside his specialty that was included in the original practice (for example, it would be unreasonable to prevent a departing cardiologist from practicing internal medicine).

**Penalties**

The penalties imposed for violation of the covenant should also be reasonable. Often, an injunction is the only way to
prevent a medical group from being irreparably harmed by unfair competition. Sometimes, however, a departing physician may buy out of the prohibition by paying liquidated damages (mutually agreed payment reflecting an agreed approximation of the cost of the harm to the group from the competition). The often-used formula is based on one-quarter to one-half of the physician’s compensation, for the prior one or two years. It is also advisable to have a ceiling on the amount of damages payable.

**Exceptions**

Although exception to the non-compete provisions are allowed, a group should only agree to compromises that can be justified in the contract as both fair and consistent with the premise that underlies the covenant. Exceptions may be dangerous, because they suggest that the non-compete clause may not be an essential protection for the group, increasing the chances that a court may find it unenforceable. For the same reasons, the clause should be only as restrictive as you are willing to enforce, and than should be enforced vigorously.

*Caveat:* In some states, such as California, Montana and Michigan, restrictive covenants are seldom enforced because of strong bias favoring unrestricted employment.

**B. Non-solicitation Provisions**

A non-solicitation provision in an employment agreement seeks to prevent the departing physician from soliciting or contacting patients, other physicians or employees of the medical group to terminate their relationship with the medical group. As is the case concerning non-competition agreements, the prohibition must be reasonable in scope and its application cannot be more restrictive than necessary to protect the legitimate interests of the medical group.

**C. Confidentiality Provisions**

The confidentiality provision of the employment agreement serves two purposes. First, it serves to define what the medical group considers to be confidential and proprietary information. Confidential information is that information that the medical group considers should be held in confidence, whereas proprietary information is that information that the medical group considers itself to own and should not be disclosed.
VII. REGULATORY CONCERNS THAT MAY BE IMPLICATED IN BUYOUT ARRANGEMENT

A. Fraud-and-Abuse Issues

Under the federal health care Anti-Kickback Statute prohibiting compensation and remuneration for referral of Medicare and Medicaid patients, there is a Safe Harbor relating to the sale of a medical practice to another practitioner.

1. Safe Harbor Standard

   a. the period from the date of the first agreement pertaining to the sale to the completion of the sale is not more than a year; and
   b. the practitioner who is selling his or her practice will not be in a position to make referrals to, or otherwise generate business for the purchasing practitioner for which payments may be made in whole or in part under Medicare or a state health care program after one year from the date of the first agreement pertaining to the sale. This safe harbor also addresses the sale of practice to a hospital or other entity, rather than to another practitioner.

B. Stark Issues

Ethics in Patients Referral Act ("Stark I"), prohibited physician referrals of Medicare patients to clinical laboratories where the physicians had ongoing financial involvement defined as “any ownership or investment interest or any compensation arrangement.” Subsequent Stark legislation ("Stark II"), rendered widespread financial consequences on practicing physicians. Stark II prohibited physicians and physician’s family members with financial relationship to an organization from referring a patient to that organization for clinical laboratory services and to any of ten additional designated health services. Stark II precipitated an immediate negative impact on the value of health care entities providing the denoted services. Those generating a large portion of their revenue from the referral of Medicare and Medicaid patients also would be dramatically stricken.

1. Services affected by Stark II

   a) physical therapy;
   b) occupational therapy;
   c) radiology and other diagnostic;
d) radiation therapy;

e) durable medical equipment (DME);

f) parenteral and enteral nutrients, equipment and supplies

g) prosthetics, orthotics and prosthetic devices;

h) home health care;

i) outpatient prescription drugs; and

j) inpatient and outpatient hospital care.

2. Valuation Implications

The valuation analysis for these entities would require:

a) quantifying historical revenues and profits resulting from such referral streams related to prohibited referral practices;

b) estimate of normalized future operating revenues and profits resulting from the exclusion of prohibited referral streams from future operations; and

c) the analysis of additional risks attributable to the operating entity and the overall future economic viability resulting from the immediate loss of significant revenue sources.

In sum, loss of referral streams reduces the value of the practice.

C. Interpretation of Valuation Protocols by the IRS

The Internal Revenue Service (IRS) has significant interest in the accuracy of valuations of medical practices. If a transaction is completed at more than fair market value, the IRS would be likely to question the health care entity’s tax-exempt status. Critical issues are whether appraisals are correctly performed by totally independent outsiders. The IRS expect all three methods of estimating Business Enterprise Value (Income Approach, Market Approach, Asset-based Approach), to be included in appraisal. To insure a correct evaluation, the Income Approach should be tested against other approaches, such as Asset-based and Market calculations.