Partner Buy-Ins

Whether signing on with a group right out of residency or after working several years as an employee in another setting, physicians may ultimately have an opportunity for "partnership" or "ownership" in their new practice. Usually this occurs at the end of a pre-determined length of employment. This means that the employee must "buy" his or her share of the practice.

Unless the buy-in formula is spelled out in the physician's original employment agreement, the buy-in must be negotiated when the physician actually is later invited to become an owner. Because this process can be complicated and sometimes even contentious, it can take a while. Once a price has been set, the new owner either pays the full amount up front or pays it over a few years, with or without interest. While the new owner receives no tax deduction for the investment, the selling owners must report any gain on the sale of the stock (the portion that they are selling to the new owner) as a capital gain.

A buy-in or purchase agreement is a formal document outlining the specific conditions and formula by which a physician may become a part owner of a medical practice. Executing a buy-in usually increases the physician's income, status, and responsibility within the organization and, hopefully, employment security. One vehicle for setting the conditions of a possible future buy-in agreement is the new physician's initial employment contract. However, both parties may want to reserve their rights to make a future judgment about whether the buy-in agreement will actually be executed. Ideally, a group should decide on a basic buy-in methodology before recruiting a new physician. How and when the numbers get filled in, however, may be subject to negotiation upon hire. A buy-in may be needed when a solo physician decides to take on his/her first partner, in which case the buy-in will be decided then.

The value of the practice is a major element of the buy-in agreement. Three main factors – tangible assets, accounts receivable, and goodwill – are used to determine the value of the practice and therefore the physician's share or buy-in amount. The tangible assets are the easiest to determine because they include cash, furniture, equipment, and other items with measurable cash value. The accounts receivable are monies owed to the practice for services already rendered. Goodwill is the value of the practice's expected future earning power. Theoretically, determining the amount that should actually be paid for the buy-in involves multiplying the sum of these three values by the proportion of ownership interest that the new doctor will receive in the practice.

There are several ways to determine buy-in value, none of which are very precise. Some practices pay for a practice valuation by an outside consultant each time a partner buys into the group. Other practices use crude rules of thumb or comparable practice sales data to calculate goodwill. Some practices use a pre-determined amount and phase in the buy-in over several years through salary reductions ("sweat equity"). Some practices choose to ignore goodwill and tangible assets and instead base the value solely

on accounts receivable. Some include all tangible assets and accounts receivable and leave only goodwill out of the formula.

The Inexact Phased Buy-In

One pragmatic solution to this valuation problem is to side-step it by substituting salary reductions spread over several years instead of calculating the traditional purchase amount. While this method avoids the potentially controversial process of assigning a dollar value to the practice, it introduces the difficulty of having to agree on the annual percentage reductions in salary and the number of years over which they will be imposed.

This "inexact" and phased buy-in method calls for reducing an incoming partner's share of ownership pay over several years (usually three to five) as part, or all, of the buy-in "payment." This is often accomplished by gradually increasing each year the percentage of a full owner's share that the new owner will receive until he or she attains 100%.

The salary reduction concept assumes that a new owner initially will be less valuable to the practice than the more experienced owners but will over time grow in experience and value. The idea is that it can take a while to build patient and referring physician relationships, assume leadership positions in the hospital and the practice, and gain experience in practice management. Although the pace of this phase-in period can be debated, the current and prospective physician owners may find reaching agreement on this subjective judgment much easier than trying to assign an arbitrary monetary value to the practice's "goodwill."

This methodology need not even require using the word "buy-in," and the absence of an actual "purchase" can be very appealing to a new recruit. It avoids negotiating over the very difficult to determine value of goodwill. And on "D-Day" when the new physician officially takes an ownership share, there may be no need for the new physician to borrow – unless a nominal "purchase" price is established for tax purposes.

The Exact Buy-In

The exact buy-in consists of setting a price for the practice and paying over a period of years. This method is more commonly used for an experienced outside physician who will literally "buy" his/her way into the group, for example someone moving to town from another location. However, if a practice has used this method for prior buy-ins, this method would just as likely be used for young physicians joining right out of residency.

For example, if a practice is valued at $2 million (including goodwill) and the group of four is adding one new physician. The new doctor must somehow pay $400,000 (1/5 of the total value) to the four existing owners. This amount could be paid in a lump sum (perhaps with a bank loan) or paid over a period of 3-5 years, or both.

One way to do it is to set up a structured plan to reduce income over a period of time after the buy-in, similar to the method described above in the inexact buy-in section. This way the new partner pays more or less depending on how profitable the practice is during the buy-in time period. Some prefer to use a specific purchase value for the receivables and goodwill instead of a percentage income reduction.

Protecting the Practice

Co-ownership is like a marriage—it is a long-term relationship that requires a lot of work, communication, dedication and perseverance. If the buy-in is not planned and written well, it could lead to an unhappy divorce. If the buy-out is not done fairly, it could leave both parties in uncomfortable positions and with hard feelings. It is therefore critically important to involve an experienced healthcare attorney in drafting the buy-in and buy-out agreement in order to protect the financial interests of all parties: the practice, incoming partners, and outgoing partners.

Restrictive covenants (for owners as well as for employees), protective limitations and caps (to protect practices that encounter financial problems after the partner leaves), "lookback" clauses (to protect against liability claims that arise after departure), and benefit carry-forwards (such as malpractice or disability premiums that will follow the outgoing partner), reductions for sick pay (for those pay-outs resulting from an illness) are all elements for possible inclusion in the buy-in or pay-out agreement. Appropriate treatment of them requires competent counsel to draft the legal language. State variations in the law as well as individual circumstances of the practice and partners involved requires detailed knowledge of tax, liability, and other legal implications to draft an agreement that is best for everyone.

Buy-Sell Agreement

One of the most important legal documents that can tie all of this together is a buy-sell agreement approved in advance of the events for which it is needed. Without an up-to-date, well-thought-out buy-sell agreement in place, a medical group can find itself in a costly fight among its owners over a change in ownership. The purpose of the buy-sell agreement is to facilitate an orderly purchase or sale of ownership occasioned by a new partner's desire to buy in or the death, retirement, disability, or other voluntary or involuntary departure of an existing owner.

For more information on "Buying or Selling a Practice," College members may download the full text free from CPII's web site at http://www.acponline.org/running_practice/practice_management/tools/