PART TWO

Group practice: Getting in and getting out unscathed

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AFTER SELECTING THE APPROPRIATE BUSINESS AND TAX STRUCTURE for the group practice, two concerns facing group practices are (1) whether the associate is ready for and can pay for the buy-in and (2) ensuring that the buy-sell agreements consider all, not some, of the buyout triggering events.

Editor's note: This article is part two of a three-part series. Part one appeared in July, and part three will appear in September. Find part one on DentalEconomics.com. Search "Prescott."

ASSOCIATE BUY-INS

Associate buy-ins should be based upon predetermined performance standards measured over time. The standards include not only productivity, but also quality of clinical treatment, effort, working relationships with patients, referral sources, and total contribution to the practice. Associate buy-ins average two to three years for general practices and one to two years for specialists.

Associate buy-ins are usually internally financed because lenders will not lend on a fractional interest unless the practice entity and/or practice owner guarantee Dr. Junior's loan. The risk for the practice or Dr. Senior is this: if Dr. Junior leaves and Dr. Senior is paid for the buy-in up front, the lender must be repaid if Dr. Junior defaults on the loan. If the practice entity for Dr. Senior guarantees Dr. Junior's loan, Dr. Junior should get very little upon departure or default, and the time period of any guarantee should be limited.

Some advisors still advocate that Dr. Junior's compensation as an associate be reduced and a portion of it held in escrow for a future buy-in. This practice is ill-advised, as there is usually insufficient profit attributable to Dr. Junior's productivity to pay Dr. Junior a competitive rate and contribute any meaningful sum to an escrow account. In addition, the funds held in escrow are taxable as ordinary income to Dr. Junior each year.

The purchase price for the associate buy-in is based upon an appraisal of the practice. Whatever valuation method is used for the associate buy-in, Dr. Junior needs to be fairly paid as an owner in order to pay the lender(s) and to pay his or her proportionate share of the operating expenses, all within a measured period of time. For associate buy-ins, I do believe that pro rata accounts receivable should be excluded from the value as should practice debt. But if pro rata accounts receivable is included, pro rata practice debt should also be included. For Dr. Junior, his or her CPA should confirm or refute the valuation report prepared by the appraiser who is paid for by the practice.

The valuation report for the practice should be completed for the calendar or fiscal year immediately preceding the associate's employment. An updated valuation report should be prepared one year after Dr. Junior works on a full-time basis in the practice. The rationale behind a valuation after one year of employment is that for at least the first year, Dr. Junior's production is from the pent-up practice demand, not Dr. Junior's efforts. Dr. Junior should not accept a valuation report prepared for the immediate year prior to ownership. Exceptions to this are (1) when Dr. Junior is entering into a solo group or (2) when Dr. Junior has the ability to purchase or become an owner of the primary practice location where he works, pursuant to a predetermined formula.

For those practices operating as S corporations, distributions must be made on the basis of ownership. For the buy-in, Dr. Junior should purchase and pay for a specified percentage of stock each year until Dr. Junior attains the agreed percentage purchase (e.g., 50% or 49%). If, on the other hand, Dr. Junior

purchases 50% or 49% of the S corporation's stock immediately without having paid for it, Dr. Junior would be entitled to 50% or 49% of the S corporation distributions.

OWNER BUYOUTS

It is essential to have the buy-sell agreement in place at the time the group practice is formed because any owner can leave the practice at any time for any reason. Triggering events include death, disability, retirement as a defined term (e.g., attaining age 62 and electing to retire, but not later than age 70), dispute, and termination of employment for any other reason, including "for cause" as a defined term.

Most triggering events should require mandatory buyouts and should be payable in cash in a two-owner practice. An exception is the business and tax structure of stock excluding goodwill where the goodwill for a departing owner is payable over time through deferred or continued compensation. Another exception is where the owners are of similar age. For such practices, there is usually not a mandatory buyout, except for death or disability. The challenge is to locate a purchaser or purchasers to buy a sizable practice. For this reason, I have reconstituted some similarly aged co-owners as a solo group of separate practices, allowing each owner to sell when ready, while still practicing in the same facility.

For practices with more than two owners, Dr. Two does not want to be affected by a newly admitted owner's or Dr. Three's purchase of Dr. One's, or Dr. Senior's, interest. An exception is when all remaining or surviving owners are required to buy out Dr. One or Dr. Senior, which is not often the case.

Both life and any disability **buyout insurance** should be consistent with the business and tax structure of the group practice.

Life insurance should be considered for death. Disability buyout insurance, on the other hand, is expensive and difficult to obtain. Disability buyout insurance should not be confused with disability income replacement or disability overhead insurance. Both life and any disability buyout insurance should be consistent with the business and tax structure of the group practice.

Buy-sell agreements should be drafted in accordance with the business and tax structure for any associate buy-in(s) and future owner buyout(s). In a two-owner practice, the remaining owner grants the practice as security to the lender to pay the purchase price. Should outside financing not be available, which can happen for very large practices, the buy-sell agreement should provide that the buyout would be seller financed and the remaining owner would pay a percentage (e.g., 2%) above the prime rate charged by the practice entity's bank on the purchase date.

The purchase price for a buyout should be determined in one of three ways: by formula, appraisal, or an agreed value. Like the buy-in, I believe that the pro rata accounts receivable should be excluded, unless the pro rata debt is included.

The formula method provides for a pro rata increase for practice growth. If a group practice significantly increases in value, the formula provides for the departing or retiring owner to share a pro rata percentage of the increased growth. On the other hand, if revenue declines, the formula accounts for a correspondingly reduced value. The rationale is that both or all owners contribute to the growth. The key for using a formula determination of a purchase price is to make it easily quantifiable and understandable.

The appraisal method can work, but the disadvantages are (1) varying appraisal results among appraisers, (2) the time it takes to prepare, and (3) the cost. However, if the appraiser is designated by name and if the specific appraiser is unavailable, an appraiser must be agreed upon by the owners with a tie-breaking mechanism should the doctors be unable to agree. Further, the buy-sell agreement should contain a provision whereby the most recent appraisal will control until the appraisal is updated. Unfortunately, small group owners usually overlook authorizing an updated appraisal.

While agreed value is definite, it does not account for future growth or decline of the practice. This agreed value is often used where the stock of a professional corporation is appraised at tangible asset value, excluding goodwill, or if Dr. Senior is retiring upon a predetermined date that is not too distant in the future (e.g., within two years). Sometimes the agreed value is coupled with a pro rata percentage of the cost of additional tangible assets and technology, as mutually agreed upon by the owners, with an exception for equipment breakdowns (e.g., a compressor, vacuum system, or x-ray tube head that must be replaced), from the date that the buy-sell agreement is signed until the retirement or other departure date.

In summary, the associate's performance must warrant the associate's elevation to ownership, the buy-in must be paid within a measured period of time without the new owner incurring a pay reduction, and *all*, not just some, of the buyout triggering events must be considered. **DE**

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