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Buy-Ins and Pay-Outs in Oral and Maxillofacial Surgery Practices

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P810

Friday, September 19, 2008
1:00 pm - 4:00 pm

All follow-up questions can be directed to AAOMS at 800-822-6637

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I. PREPARING FOR CO-OWNERSHIP

A. Associate Period

1. Employment versus expense sharing
    a. Basic differences
2. Term
    a. Is co-ownership a given?
    b. Duration of time to co-ownership
    c. A short timeframe?
        (1) Negotiation power of the parties
        (2) Sense of “need”
3. The Evaluations Period Preceding Co-Ownership
    a. Criteria for basic continued employment clarified in advance
    b. Typical criteria include
        (1) Commitment
        (2) Productivity and efficiency
        (3) Acceptance of practice burdens and responsibilities
        (4) An entrepreneurial ambition
        (5) Personal and professional rapport
        (6) Timely board certification
    c. Feedback provided
        (1) Financial performance
        (2) Status on partnership track
        (3) Reasonable corrections in "behavior," and sufficient time for corrections to work
4. Promises Made
    a. Timing

b. Details

(1) General co-ownership offer

(2) Any restrictions?

(3) Any there any qualifications on the likelihood of the offer?

c. Solo-practices recruiting new associates

(1) Practice at risk in the event of solo's death or disability

(2) Locked in purchase or not?

(3) Pros and cons of these arrangements

(4) Pre-negotiation of terms

B. Reasonable Expectations

1. Development into "Partnership" Material

a. Promoting the behavior

b. Clarity of the "partnership track"

C. Compensation Leading up to Co-Ownership

1. Determining Basic Starting Salary and Increases Prior to Co-Ownership

a. Associate's value in the marketplace

b. Practice factors

c. Supply and demand

d. Salary range variable - average starting salaries

2. Bonuses

a. Personal Production –"Eat what you kill"

(1) Certain percentage of receipts produced in excess of a predetermined threshold

b. Incentive based on practice's net income

(1) Profit growth –make the pie bigger

(2) The associate shares in the increase in the net income available to the owners

(3) Promotes philosophical alignment if done properly

c. Discretionary bonus

(1) The “Trust me” Bonus

d. Final word about bonuses

(1) They need to be simple

(2) They need to be achievable

(3) But do not pay the associate like a partner yet

D. Income Track to Ownership

1. Gross Income Expectations
2. Net Income / Profitability Expectations
3. Income Principles for Co-Owners
   a. New associate economics
   b. Overhead
   c. Sufficiency of economic contributions
4. Problems with Shortened Tracks to Co-Ownership
5. Other Types of Contributions
   a. Referral base
   b. Trust with the business
   c. Management

II. THE BUY-IN

A. What it means to be a "Partner"

1. From Associate to Partner
2. Responsibility for Business Development
   a. Continuing responsibility
   b. Responsibility for maintenance AND development
3. Accountability for Performance
4. Demonstrated ability to trust and be trusted

B. Critical Evaluation

1. Evaluation Process Implemented During Associate Period
    a. Notice of problems
    b. Time to remedy
2. No promises
3. Firing an Associate Versus Divorcing a Partner
    a. Long-term differences
    b. Liability
    c. Better to do early

C. Values Involved with the Buy-In

1. The "Big Three"
    a. Equity and "hard assets"
    b. Accounts Receivable
    c. Goodwill
2. Net Book Value / Equity
    a. Why purchase equity?
        (1) Use of owner cash
        (2) Return on equity
        (3) Liquidation value/rights
    b. Cash assets
        (1) Values on-hand
        (2) Prepayments
    c. Modified book value for the actual “hard assets”
        (1) Section 179 write offs
        (2) Restate depreciation, but watch technology
            (a) Depreciation is a tax issue, not a valuation issue
            (b) Restate depreciation usually over 10 – 12 years

(c) Watch assets that depreciate quickly (computer software, etc.)

(d) "Floor" value

(3) Capitalized leases

(4) Exclude truly personal items

(a) Cars

(b) Personal effects

d. Net book value figure

(1) Book value *less* debt

(2) What is included in debt?

e. Timing of the valuation

f. Formula approach versus appraisal

(1) Why use a formula approach versus appraisal?

(a) Simplicity of the valuation

(b) Ability to implement a valuation at any time without involving "experts" (and therefore other fees)

(c) There are times when a specific appraisal may be warranted

3. Accounts Receivable

a. Why buy into them in the first instance?

(1) Whose are they anyway?

(2) The associate's claim that he or she is the one who worked to generate them (at least in part)

(a) The associate was (has been) paid to generate collections

b. What are the alternatives to buying in to the accounts receivable?

c. How to value them

(1) Face value for "current" accounts

(2) Disregard “old” accounts

(3) Discount by the historical collection ratio

d. Timing of the practice A/R valuation

(1) Use either year end, or running average of open collectible accounts receivable

e. Minus accounts payable?

4. Goodwill Value

a. What is it?

(1) Opportunity cost

(2) Income and referral stream

(3) Enterprise value

(4) Institutional value

(5) Inherent values

(a) Enforceable restrictive covenants and non-solicitation agreements

(b) Patient records

(c) Business relationships, contacts, and community recognition

b. Does it exist?

(1) It may depend

(2) The parties often look at this issue very differently

(a) From junior’s perspective, you may only be worth what you can produce

(b) From senior’s perspective, junior is only able to produce in the first instance because of the work that senior did in establishing the referral sources, building the business, etc.

c. Guidelines for OMS

d. Goodwill value benchmarks

5. Valuation Standards and Methods

a. Internal Revenue Services Guidelines

b. Three primary valuation methodologies

(1) "Excess Earnings"

(2) "Discounted Cash Flow"

(3) "Comparable Sales"

D. Other Practice Values

a. Inventories

b. Leasehold interests and improvements

c. Contractual arrangements

d. Real estate

E. The Stock (Equity) Purchase

1. How Much Equity Will Be Offered / Sold?

a. Selling the entire interest at once

b. Annual incremental sale issues

c. Tax implications of the differences

d. Valuation implications

e. Control issues (see below)

2. Valuation date

a. Typically measured as of the practice year-end

b. Alternative measurement dates

3. Purchase of an "equal" interest

a. Is the new partner equally important?

b. "Senior Partner Protections"

(1) Ability to retain certain items

(a) Ability to prevent liquidation

(b) Trade-off for (early) equal ownership

(c) Limited time period of superior rights

(d) Tie to buy-in period (or perhaps longer)

(e) Is it fair?

(f) Is it needed in a multi-partner group?

4. Common Payment Terms

a. Purchase of the interest directly from the existing partner(s) versus from the practice

b. Lump sum payment

c. Installments with interest

F. The Goodwill and Receivables Purchase

1. "Exact" and "Inexact" Valuation Methods

a. Exact method

(1) Value A/R

(2) Value the goodwill

b. Inexact method

(1) Rough calculations of discounts

(a) For example, accounts receivable equal 2-3 months of gross income

(b) For example, goodwill equals 40% -50% of gross income

(2) "Discounts"

(a) 60% - 70% - 80% - 90% - 100% = 100% of the net income share or variations

(b) Remembering that the new associate is buying into a share of the practice

(3) Logical justifications

(a) A "good deal" for both sides

(b) Self corrects for higher / lower gross / net income and fluctuations

(c) Viability in a changing health care environment

2. A "Buy-In" or a "Compensation Plan?"

a. What income is subject to these discounts?

(1) Defining "Net Income" –owner compensation

(a) Salary and bonuses

(b) Retirement plan contributions

(c) Fringe benefits

(d) "Semi-personal" business expenses

(e) Practice profit or loss

b. How should the discounts be reallocated?

c. What are the income division principles?

(1) Defining how partners divide the income

(2) Traditional methods

(a) All divided equally or all on relative production

(b) A portion divided equally and a portion divided on the basis of the relative production

(c) Example:

(i) 30% – 40% divided equally

(ii) 70% - 60% divided on the basis of relative production

G. Related Issues

1. Managing Partner

a. Principle reasons for the managing partner

b. A payment for the assumption of responsibility

c. Common payment range for this role when provided by an owner

d. Does this depend on the size of the group?

2. Ongoing Restrictive Covenant

a. Should the practice limit the post-employment activity of its partners?

b. If post-employment competition is permitted, does that competition result in a loss/reduction of "Separation Pay"/Deferred Compensation?

3. Indemnification of new co-owner for prior liabilities

a. Indemnifications generally

(1) Common legal principles

(2) Billing liabilities

(3) Tax liabilities

(4) Malpractice liabilities

b. Limitations on indemnifications

(1) Insured liabilities

(2) Uninsured liabilities

H. Legal Documents

1. Typical agreements involved

a. Employment agreement

b. Shareholder agreement

c. Promissory note

d. Other possible agreements

(1) Bill of sale

(2) Escrow agreement

(3) Restrictive covenant agreement

III. THE PAY-OUT

A. Practice Valuation upon Departure

1. Consistency in Principles and Valuation Approaches
2. General Concepts on Pay-Outs
    a. You need to have your deal in place in advance of "needing" it
    b. You should never assume that the buy-out will go first to the oldest member
    c. If there was no buy in, you are likely to have issues in commanding a buy out
    d. Fairness is paramount to making this work
3. Two Parts
    a. Stock / equity redemption
    b. Deferred compensation / separation pay
4. Three Values
    a. Assets (balance sheet items)
        (1) Same net book value method for valuing the equity interest
        (2) Same payment principles generally apply
    b. Accounts receivable
        (1) Same valuation principles should apply
    c. Goodwill

B. Stock / Equity Repurchase

1. Valuation Formula Based Principally on Tangible Assets
2. Who purchases the interest
3. Is the purchase permissive of mandatory?
4. Form of payment: lump sum or installments?
5. Shareholder or operating agreement

a. Sets value

b. Determines terms on sale/purchase of equity

C. "Separation Pay"/Deferred Compensation

1. Contrasted with Equity Purchase

   a. Tax treatment of deferred compensation versus “all stock” purchase

2. Deciding on the Pay-Out Amount

   a. Accounts receivable

   b. Goodwill value of ongoing practice

   c. Year's pay (or partial year’s pay) principle

      (1) Buy-in valuation principle

      (2) Logical justification

      (3) Defining the compensation

         (a) W-2

         (b) K-1

         (c) Other?

3. Deferred over number of years

4. What about “partial retirement?”

5. Related entity buy-outs

D. Funding a Pay-out

1. Funding from Ongoing Earning Capacity

2. Use of Insurance(s)

3. Creating Reserves to Fund Buy-Out’s

4. Ongoing Partners' Personal Guarantees?

E. Limitations on Deferred Compensation to Protect Ongoing Practice

1. Reduction if Departed Member Leaves and Competes or Solicits

2. Reduction if Group Income Decreases

3. Reduction for Sick Pay

4. Reduction for Short Notice

5. Reduction for Post-Separation Benefits

6. Reduction for Post-Separation Liabilities

IV. OTHER CONSIDERATIONS

A. Buy-Ins / Buy-Outs Involving Related Entities

1. Timing

2. Valuation

3. Permissive or Mandatory?

4. Each Entity Requires Advanced Planning

5. Not all Departures Allow You to Negotiate with Your Partner(S)

WHAT SHOULD IT MEAN TO BE A "PARTNER"?

Doctors rarely have any real idea why their group members are "partners" or what responsibilities they should assume as such. We suggest, however, that you critically evaluate your young doctors against your definition of "partner" and that you tailor your own activities to the definition as well.

Doctors have what we believe is an unfortunate policy as to their associates. They consider these young doctors as their "partners" virtually from the date of hire, and they promote these people almost automatically to legal co-ownership status after just a few years. They never really face the question: What should it mean to be a "partner?"

Is a partner simply a doctor who has stayed with your practice for a few years, at least having been good enough not to be asked to leave? Or is a partner someone who exhibits those business and entrepreneurial capacities within your practice that will help the group continue to prosper?

Producer Versus Executive

Compared to commercial business, professional service groups traditionally have one serious problem: the owner/executives are also the hands-on producers of the income. In commercial companies the owners and executives instead run the business while machines and/or employees produce the goods. Medical practices must begin to recognize this need for owner/executive time versus producer time, and hence a "partner," by definition, should be important to his or her practice as an owner/executive.

On this basis, a young doctor might not necessarily be partnership material even if he or she possesses excellent clinical traits -- those of a good producer. A group definitely needs these fine people, and it should pay them generously, but they might not be good candidates for partnership. Law firms function this way, as do accounting and architectural firms; there is no reason why medical groups should not logically be moving in the same direction.

Reducing a Partner's Production

To become better able to run a group practice in a complex environment, there should be a movement towards reducing partners' clinical time requirements and replacing it with associate-level production. Partners should not, however, necessarily take this as an opportunity for more time off. Instead it provides them the time for executive work ~ developing a new satellite, seeking out new provider approaches, taking the lead in making decisions, or whatever. It would help them avoid making such damning statements as we heard from a recent client: "We've been too busy to market ourselves to more referring doctors," and "We never had the time to be tougher on making new partners."

To whatever extent your practice needs business involvement, it must start by identifying a partner's obligations. If that person is to be responsible for practice success as one of its co-owners, then the definition leads to our points: be more critical in promising partnership, and strive to reduce partner-level clinical time so he/she can assume real ownership/executive responsibility.

BUY-IN CHECKLIST

1. Co-ownership Arrangements Letter Agreement

2. Obtain stock purchase price calculation from accountant and verify

3. Bill of Sale

4. Promissory Note

5. Stock Option

6. Shareholders' Agreement

7. Unanimous Consent of the Shareholders and Board of Directors

8. Compensation Arrangements Letter Agreement

9. Employment Agreement