Ophthalmology Practice
Buy-In and Pay-Out
Arrangements
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Plymouth Meeting, PA
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* Financial Interest

Financial Interest Disclosure

We have the following financial interests or relationships to disclose:

- Shareholders of and Consultants with The Health Care Group, Inc. and Health Care Consulting, Inc.
- Shareholders of and Attorneys with Health Care Law Associates, P.C.
Who We Are

• Business and legal advisors to ophthalmologists and other physicians
• Advise re: new doctor employment agreements, buy-ins, pay-outs, practice sales, valuations, income division arrangements, etc.
• Publishers of the Goodwill Registry, used in ophthalmology practice valuation

Buy-in Planning

• Plan ideally begins prior to first employment agreement
• Set expectations, outline terms
• But, no promises
• Critical evaluation, feedback, notice of problems
• Firing associates vs. divorcing a partner

More Than a Buy-in

• Four things happening simultaneously
  • Buy-in
  • Governance / Decision Making
  • Income Division
  • Pay-out
Formal Valuation of Practice?

- Not strictly necessary
- Review financials
- Ball park values usually involved
- Evaluate financial feasibility

Method and Structure for the Buy-in

- We’ll assume the practice entity is a PC
  - But the same principles apply to LLCs and other entities

Two Part Process

- Stock purchase (equipment)
- Income discounting (accounts receivable and goodwill)
Tax Considerations

- Stock purchase → capital gain for senior doctor, but is paid with after-tax dollars
- Income discounting → ordinary income for senior, but is paid with pre-tax dollars

Financial Feasibility

- The deal should be affordable for new partner
  - If buy-in creates big pay cut for new partner, it is not going to be “saleable”

Values Involved in the Buy-in

- The big three
  - “Hard assets” (equipment, buildouts)
  - Accounts receivable
  - Goodwill
Hard Assets

- Modified net book value
  - Eliminate equipment no longer in use
  - Add back section 179 assets
  - Restate depreciation
    - Straight-line depreciation over 8 - 12 years (typically 10)
    - 20% minimum value

- Include capitalized (non-operating) leases
- Exclude personal items (automobiles, artwork, etc.)

- Modified net book value
  - Less debt and other liabilities
  - Equals net equity of stock (100%)
  - Times percentage purchased
  - Example
## Inventory/Supplies

- Could be physical inventory at time of stock purchase
  - # of units times cost per unit

## Inventory/Supplies

- Or an estimated amount based on annual expense times number of months of stock kept on hand
  - Annual medical supplies expense is $120,000, so one month's stock is valued at $10,000
Accounts Receivable

- As of start of partnership
- Excluding deadwood
- Face value times reasonable, historical collection ratio
- Example

ACCOUNTS RECEIVABLE

THE EYE CENTER GROUP, PC

A/R as of 12/31/2016 $755,000
Minus A/R More Than 180 Days Old $55,000
Adjusted Gross A/R as of 12/31/2015 $200,000
Multiply by Gross Collection Percentage (from below)

Net Accounts Receivable as of 12/31/2015 $180,000

Goodwill Value

- Value of up-and-running operation
  - Office space, equipment assembled, trained workforce, policies and procedures, phone numbers, website
  - And value of patient base
- Guidelines for ophthalmology
Goodwill Value

- The Health Care Group® Goodwill Registry
  - A database of comparables
  - Tracks goodwill values paid in actual buy-in and sale transactions
  - Specialty specific
  - Rolling 10 year average

Sample Goodwill Data Point

- Practice with one owner and one associate has revenues of $1.5 million
- Goodwill valued at $450,000 in total
- Data point for Goodwill Registry is 30%
  - A “30% goodwill factor”

<table>
<thead>
<tr>
<th>Year(s)</th>
<th>Goodwill %</th>
<th>Notes</th>
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<tbody>
<tr>
<td>2006 - 2015</td>
<td>27.43%</td>
<td>10 Year Average</td>
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<tr>
<td>2011 - 2015</td>
<td>28.81%</td>
<td>5 Year Average</td>
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<tr>
<td>2012 - 2015</td>
<td>29.17%</td>
<td>4 Year Average</td>
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<td>2013 - 2015</td>
<td>29.14%</td>
<td>3 Year Average</td>
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<tr>
<td>2014 - 2015</td>
<td>30.38%</td>
<td>2 Year Average</td>
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<tr>
<td>2006</td>
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<td>2007</td>
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</tr>
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</tr>
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<td>2011</td>
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<td>25.82%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>26.11%</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>34.44%</td>
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Source: Goodwill Registry 2016
Using the Benchmark

- If the benchmark is 30%, and Practice has revenues of $2.0 million
- Goodwill valued at $600,000 in total
- 50% equity purchase means price paid for goodwill is $300,000

Co-ownership

- What should the stock ownership be?
  - 51%/49%?
  - 50%/50% with special protections for founder?
  - Other split (e.g. 90/10)?

Will Stock % Affect Compensation?

- Generally not unless you want it to
- Most $ are divided either on productivity or by equal split or other formula
- The formula is agreed by contract
- Not dictated by stock ownership %
Will Stock % Affect Control?

- Yes…. but there are alternative ways to achieve control
- Example: A 50/50 split with “Senior Doctor Rights”
  - Right to manage day-to-day operations
  - Option to repurchase shares of new partner, if there is a falling out

Other Factors

- The “message” of 50-50 versus 51-49
  - or 33.3-33.3-33.3 versus 51.0-24.5-24.5
- Presents as more of an “equal partnership” with 50-50, even if senior doctor has certain legal rights via Senior Doctor Rights

Fairness of Senior Doctor Rights

- Trade-off for (early) equal ownership
- Typically time-limited (e.g., 5 years, or until senior doctor retirement)
- Is it fair to the associate?
- Is it fair to the practice not to have it?
Other Stock %s

• 90%/10%?
  • No real difference from 51-49 or 50-50 in terms of compensation to doctors
  • Concern is that new partner is getting access to the full profit on his services
  • While not buying into much of asset base

The Stock Purchase

• Price is based on hard assets only
  • Goodwill and AR are separately handled: via income adjustments
  • Generally seller financed
  • Modest downpayment
  • Remainder over time with interest (prime or prime plus 1%)

Income Discounting

• The “other half” of the buy-in process
  • Reflects value of AR and goodwill
  • Typically accomplished over 3-5 years
Income Discounting

• What is being discounted or adjusted?
  • The new partner’s share of “net income”
  • “Net income” means more than salary. It typically includes tax return profit, retirement contributions, auto, seminar, and maybe health and other fringe benefits

Income Discounting

• First determine total Practice net income
• Then: what share does each partner get (BEFORE income discounts):
  • Equal splits OR
  • Productivity OR
  • Base salary plus bonus OR
  • RVUs, cost allocation, etc. etc.

Income Discounting

• Now reduce the new partner’s share of net income for the buy-in
• There are two ways to discount:
  • “Exact” method
  • “Inexact” method
Income Discounting: Exact Method

- Determine value of AR and Goodwill
- Multiply by percentage of equity to be acquired
- Remove from new partner income share over 3-5 years

Exact Method Example

- Goodwill value is $500,000
- AR value is $100,000
- Total $600,000
- Associate buys 50%
- His net income share is reduced by $300,000 over 4 years
- $75,000 per year

Income Discounting

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<th>Discount</th>
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<th>Junior</th>
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Income Discounting: Inexact Method

- Reduce new partner’s net income share by percentages rather than fixed $$ amounts
- Typically the percentages add to 100% over 4 years: “1 times net”
- The new partner is giving up the equivalent of 1 year’s pay, over 4 years

Income Discounting

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</table>

Income Discounting: Inexact Method

- The example given is: 40/30/20/10 = 100
- But can do other numbers as well: 25/25/25/25 = 100
- This gives the new partner more cash flow on the front end
- Reduce chances of paycut compared with associate salary
Inexact Method: the Philosophy

- Goodwill valuation is not a precise science
- Inexact method is an alternative that:
  - provides a reasonable compensation progression and buy-in
  - without claim to precision in terms of goodwill valuation

Inexact Method Philosophy

- Inexact method “self-adjusts”
  - If practice performs better than expected → the buy-in will be larger
  - If the practice performs more poorly than expected → buy-in will be lower
  - The buy-in “price” adjusts to performance

Pay-out Planning

- Pay-out arrangements should be in place before or at the time of the associate’s buy-in
- The buy-in documents “pre-specify” the payout to any shareholder who dies, becomes disabled, or retires
Pay-out Planning

- Remember, there were four things happening simultaneously in a buy-in
  - Buy-in
  - Governance / Decision Making
  - Income Division
  - **Pay-out**

Method and Structure for the Pay-out

- Two part process
  - Stock repurchase / redemption (equipment)
  - *Separation Pay* / *Deferred Compensation* or *Severance* (accounts receivable and goodwill)

Method and Structure for the Pay-out

- Tax considerations
  - Repurchase of departing doctor’s stock is capital gain to senior (but non-deductible to corp)
  - Severance/deferred compensation is ordinary income to senior (but deductible to corp)
Practice Valuation Upon Departure

• Same assets and valuation as for the buy-in
  • “Hard assets”
  • Accounts receivable
  • Goodwill
  • Other values

Stock Repurchase / Redemption

• Modified net book value of hard assets, less liabilities
  • Same formula as buy-in
  • Only calculated as of a new date
  • Downpayment plus installments with interest

“Separation Pay” / Deferred Compensation

• Deciding on the pay-out amount
  • Accounts receivable
  • Goodwill value of ongoing group
• But when will it be calculated?
  • 6 months from now?
  • 20 years from now?
"Separation Pay" / Deferred Compensation

- Oftentimes the “one times net” concept is the agreed amount.
- Departing doctor gets a year’s salary, paid out over 60 months (no interest).
- “Year’s salary” may be the most recent year, or an average of past 2-3 years.

Funding a Pay-out

- Use of insurance: life, disability.
- Not feasible to create corporate reserves.
- Payout should be affordable, even if no insurance proceeds are available.
  - I.e., funding from ongoing earning capacity.

Limitations to Protect Ongoing Group

- No deferred comp if doctor competes or solicit patients.
- (Maybe) no deferred compensation if doctor was terminated for “cause”.
  - E.g., loss of license, bad behavior.

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More Limitations

- Reduction for short notice given for voluntary termination of employment
- Reduction for sick pay previously received

More Limitations

- Deferral of payment if group's revenue decreases in payment period
  - E.g., if scheduled payments exceed 5% of group's total revenues in the year of payment, then excess is deferred to later year
  - Put another way: the payouts to one or more departed doctors in any given year can never be more, in total, than 5% of the group's revenue in that year

Limitations to Protect Ongoing Group

- Reduction for post-separation benefits
  - Malpractice insurance
  - Health, disability, and life insurance
  - Other benefits
QUESTIONS?