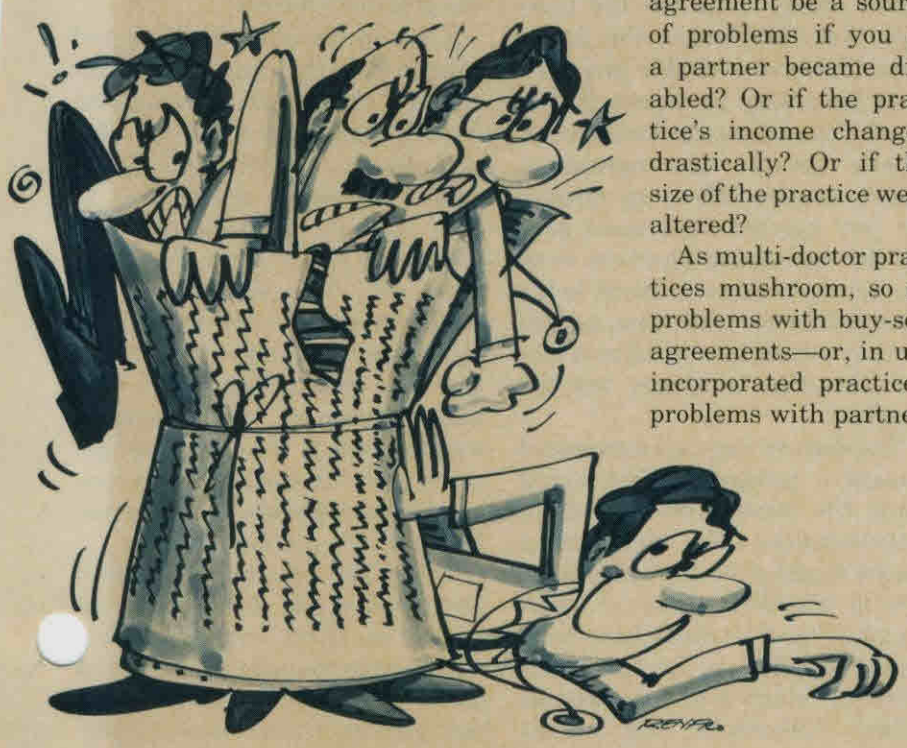
EXPENSIVE BLOOPERS IN BUY-SELL AGREEMENTS

Save yourself some big headaches by learning from the mistakes of physicians who assumed they had everything locked up tight.

By David J. Schiller, J.D.

On the surface, a buy-sell agreement between doctors joining together in practice is just a handshake on paper. But surface appearances can be deceiving. I've seen buy-sell agreements that eventually caused bitter disputes and financial hardships for both the doctor leaving the practice and the doctors staying behind.

"That couldn't happen in *my* practice," you're probably saying. "My colleagues would never do anything to harm me." And provided no crisis arises, you're probably right. But ask yourself this: Would your buy-sell agreement be a source of problems if you or a partner became disabled? Or if the practice's income changed drastically? Or if the size of the practice were altered?



As multi-doctor practices mushroom, so do problems with buy-sell agreements—or, in unincorporated practices, problems with partnership agreements. The following cases illustrate some common problems I've encountered. Could you encounter these problems? Let's hope not, but you can make sure you won't by checking now.

Is your buyout based on current salary?

Three doctors in Pennsylvania had a thriving surgical practice. Their buy-sell agreement specified that if one of them left the practice, he'd be entitled to a year's salary, based on his most recent W-2.

Four years after the agreement was drawn up, the senior doctor gave up surgery and restricted his practice to office visits, causing his share of practice income to drop from more than $100,000 to $35,000. A year later, he retired. Since his buyout was based on his most recent year's salary, the doctor was entitled to only $35,000. Had he retired outright the year before—instead of cutting back—he would have received more than $100,000.

The remaining doctors admit-

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ted that their senior partner was snagged by his own buy-sell agreement. But they too were in a financial bind. Just before the senior doctor's retirement, one of the other two had suffered a heart attack and gone on disability. The practice's income shrank by two-thirds. Not surprisingly, the remaining partner refused to pay out more than the $35,000 the buy-sell agreement required. The senior doctor had no recourse.

To prevent this type of problem, make sure your agreement allows a doctor to negotiate his payout *before* he limits his hours or cuts back his duties. That way, he won't be penalized for slowing down instead of retiring. If the doctors can't agree on what the payout should be in case of a cutback, the doctor who wants to curtail his practice might consider leaving the practice outright, collecting his payout, and then offering his services to the practice on an hourly basis.

Are you setting yourself up for a double payout?

One of the senior doctors in a five-doctor anesthesiology group suffered a heart attack and remained on disability for 10 months. The practice paid his full salary for the first six months and disability insurance paid half his salary after that.

He returned to practice, but found he couldn't keep up and retired a month later. According to the terms of the buy-sell agreement, he was entitled to half a year's salary if he left the practice. Yet this meant the doctor would receive a double payout—once for salary payments during disability and once for retirement. That's because the agreement didn't require offsetting disability pay against retirement pay. So the remaining partners were forced to pay twice as much to the disabled doctor who then retired as they would have paid to a doctor who died or simply left the practice.

The doctors' buy-sell agreement needed a paragraph that would limit the payout under certain circumstances. For instance, a clause might state that after a period of disability, a doctor must spend at least as much time back in the practice as he spent disabled to collect a full retirement payout. Otherwise, his payout would be reduced by the amount he collected while disabled.

Is your buy-and-sell payout too rapid?

An OBG specialist in New Jerse took on a junior partner two years ago. The senior doctor was well-established in the community and consequently earned two-thirds of the practice's income.

Then he became disabled and retired from the practice. The income of the practice plummeted from $500,000 to $170,000. But according to the buy-sell agreement, the junior doctor had to come up with $100,000 over the next three years to buy the senior man out. The younger doctor might have been able to renegotiate the payout except for one problem: The senior doctor died soon after retirement. So instead of working out a friendly arrangement with his partner, the younger doctor ended up in a bitter dispute with his colleague's heirs.

This situation could have been prevented if the doctors had included in their buy-sell agreement a provision that limited the payout to a percentage of the practice gross each year—say, 10 per-

cent. By limiting the annual payout to a percentage of gross instead of a flat figure, the remaining doctor could have met the payout without causing strained relations or legal battles.

Will a departing physician still own your real estate?

If your practice has owned its office building for a few years, chances are it has a gold mine of appreciation locked inside. And a departing physician may be reluctant to sell out his share of that asset for a couple of reasons: First, because he'll have to pay taxes on the sale, and second, because if he retains some ownership, he or his heirs can receive income from it in the form of rent.

But allowing a departing physician to remain a landlord can have disastrous effects. A seven-doctor incorporated family practice in Connecticut learned this the hard way. The seven doctors owned equal shares in an office building that had quadrupled in value since they bought it. Over a four-year period, two of the seven doctors retired, one became disabled, and one died. Three new doctors joined the practice to replace the departing members. But the original seven families still owned the building.

As long as all the doctors shared the practice's income and ownership of the building, any rent the doctors charged the corporation came back to them as income. Now, however, not all the rent the corporation paid flowed back to the doctors in the practice. Worse yet, when the corporation's five-year lease came up for renewal, the retired doctors or their heirs—who now had a majority interest in the building—jacked up the rent 30 percent. The practicing doctors wanted to expand the building's office space by knocking down some walls. The other owners refused; what was good for the practice was no longer in their best interest.

In this case, the majority of the building's owners no longer worked in the practice, yet they pulled the strings. But what if the opposite had been true? If just one doctor had left, it's likely the other doctors would have voted to keep rents low, and the departing physician would have suffered a loss of income by holding on to his share of the real estate.

That's why it's important to tie ownership of the practice's real estate to the ownership of the practice. To do this, your buy-sell agreement should require that a departing physician sell his share of real estate to the other doctors at current fair market value, and that the other doctors or the corporation buy it. The remaining doctors should have no trouble securing a mortgage to buy out their partner. If there's disagreement over what the fair market value of the property is, each side can choose an appraiser who will in turn agree on a third appraiser, and the three can determine a fair price for the property.

The departing physician may also choose to be the mortgage lender. By arranging an install-

ment sale, he'll collect interest on what's still owed him and spread his tax liability over several years. But if you're the departing physician and plan to go this route, make sure you keep your name on the property deeds until the mortgage is paid up. Otherwise, if your partner or partners die, you may have to go through the rigors of probate to collect your share of the real estate.

Does your agreement contain a restrictive covenant?

Besides accounts receivable and hard assets, much of the worth of a practice is good will. When a physician leaves to set up a competing practice, he takes a chunk of the practice's goodwill value with him, so he shouldn't be entitled to a goodwill payout.

However, some buy-sell agreements ignore this issue. Take the case of a three-doctor pulmonary group in Pennsylvania. One of the doctors became dissatisfied with the practice and set up his own practice in the same office building. But because the doctors' buy-sell agreement had no provision to halt a payout in this situation, the two remaining doctors were forced

"If my father wanted you to have a raise, he would have mentioned it in his will."

to pay their former partner a year's salary while he competed with them in their own office building.

In states where restrictive covenants are legal, a well-drawn one can avert such a situation. You need a provision in your buy-sell agreement that says, "If you leave the practice and set up a competing practice within x miles and y years, you'll get your share of current accounts receivable and hard assets, but nothing for good will." Ideally, this will make your restive partner think twice about setting up shop just down the street, but isn't so restrictive as to raise dark thoughts in a judge's mind about being anti-competitive and contrary to the public interest. However, if your partner leaves, collects his goodwill payout, and then returns to your area before the restrictive covenant expires, you'll have to sue to get the money back.

Must you show cause to get rid of a difficult partner?

I'd be willing to bet that 75 percent of the buy-sell agreements out there have a paragraph that lists the causes for which a partner can be expelled from the practice. These causes are usually extreme: loss of medical license, a felony conviction, mental incompetence.

It would seem fair not to terminate a partner except under extreme circumstances. But I've seen entire practices go down the tubes because of one partner's constant irritability. Not long

ago, three young surgeons from New Jersey complained to me that their fourth partner, a 55-year-old doctor, had become increasingly difficult to get along with. He yelled at patients and nurses, disrupted staff meetings, demanded that his call schedule be reduced, and refused to agree to any changes the other doctors wanted. Things were so bad that patients and referring doctors had started turning away from the practice.

The doctors would have liked to oust him from the practice by majority vote. But their buy-sell agreement listed the conditions under which he could be terminated, and "general irritability" wasn't one of them. They finally did get the fourth partner to leave—but they had to pay a heavy premium in addition to his payout to get him to agree.

That's why I recommend that buy-sell agreements state that any partner can be removed from the practice for any reason by majority vote. As harsh as that may sound, the practice should come first. The partner forced out should be entitled to the same payout as a doctor who leaves voluntarily, but you won't have to bribe him to leave.

If your buy-sell agreement doesn't contain these provisions, what should you do? First, talk to your partners. Most of these provisions are as beneficial to a doctor leaving a practice as to the ones staying, so you should be able to reach an agreement quickly. Once you all agree, notify your attorney that you'd like to add to your buy-sell agreement. You probably don't need to have a new document drafted. Just add the clauses to the old one.

Keep in mind too that a buy-sell agreement need not be engraved in stone. If the practice changes or you and your partners decide you want to revise the agreement, you can. Just don't wait until a crisis hits. Otherwise, you could end up like these physicians. ■

Scared away

As I discussed a patient's case in my consultation room, I wasn't aware that the 4-year-old grandson she'd brought along was looking around wide-eyed. I later learned that he'd paid particular notice to the 18-inch, built-to-scale skeleton that reposes on my desk. When they left the office, the boy told his grandmother that he'd never want to go to that doctor. When she asked why, he said: "Didn't you see what he does to little kids?"

—*Howard J. Ickes*, M.D.