telephone at 804-967-9604 or by e-mail at kgillespie@hdjn.com. For more information, visit www.hdjn.com.

Peer reviewed by: John B. Mumford, Esq., Richmond, Va., 804-967-9604, jmumford@hdjn.com.

4.6 The 10 Biggest Legal Mistakes Physicians Make in Buy-ins
By Michael F. Schaff, Esq.

Executive Summary
Each year, employed physicians are given the opportunity to buy in to the medical practices in which they are employed. Although this seems like a simple and natural step in the lifecycle of the association between a physician and his or her employer, significant issues are involved in this important event. Often, physicians do not understand the economic and legal significance of buying in to a medical practice and the "potholes" into which they may fall along the way. Mistakes physicians make in their buy-in may have serious economic and lifestyle effects on them and their families for years to come. Thus, it is imperative that physicians learn to spot these issues and avoid their often dire consequences.

Mistake 1 <u>**Failing to Consult with Professionals During a Buy-in**</u>
A common mistake physicians make in the buy-in process is not hiring their own professional advisers, including an attorney and an accountant. Physicians who have worked for a practice for a number of years may not believe that it is appropriate to do so or they may fear that it will be viewed as insulting if they hire their own professional advisers to evaluate the practice and assist them in the buy-in process. A physician buying into a practice should not feel uncomfortable, since the practice and the existing physicians expect the physician to hire appropriate professionals to advise him or her during the buy-in stage. In fact, the existing owners most likely engaged their own professionals to assist them in their buy-in. Specifically, a physician should not rely on the practice's attorney or accountant for advice during the buy-in process, since those professionals have a potential conflict of interest and may put the interests of either the senior physicians or the existing practice over the physician buying in.

Action Step Physicians should consult with experienced professionals, accountants, and attorneys who specialize in representing physicians in the buy-in process before negotiating the buy-in to a medical practice.

Mistake 2 <u>**Failing to Negotiate the Terms and Conditions of the Buy-in at Commencement of Employment**</u>
Physicians joining a practice have a unique opportunity to negotiate the terms of the buy-in before joining the practice as an employee. This is the ideal time for a physician to negotiate

the buy-in because it is then that he or she has the most leverage, since the practice has a recognized need to expand and the physician is not yet committed to the practice. Also, at this point, physicians have not yet altered their professional and personal lifestyle and are not subject to a restrictive covenant that could weaken their negotiating position if the buy-in is negotiated toward the end of an employment period. In sum, physicians will be able to walk away from the relationship, with little or no harm, before it has started and they are free to accept another offer if they do not like the proposed terms of the buy-in. It may not be as easy for a physician to walk away once he or she has been an employee for a year or more.

Among the questions to ask about the buy-in before commencing employment are the following: When will the physician be offered a buy-in? How is the purchase price determined? How is the purchase price paid? What does it mean to become an owner in terms of compensation and decisionmaking? Will any of the senior owners be retiring shortly? If so, what will their buyout be? Again, physicians have the most leverage to negotiate these terms before they begin to work for the practice.

Action Step Physicians should discuss and understand the parameters of a future buy-in at the time they first become employed by the practice. They should show their new employer that they are thinking about the future and are detail oriented. Also, physicians should be sure that the employment agreement sets forth the terms of the buy-in.

Mistake 3 **Failing to Analyze the Tax Treatment of the Purchase Price**
Physicians generally do not focus on the tax treatment associated with the buy-in, even though the allocation and structure of the buy-in amount could have a significant tax effect on them and the amount of money they receive. For example, if the buy-in amount is $100,000 and characterized as an ownership purchase, the physician must earn about $167,000 to pay the practice the $100,000, because he or she must pay taxes of about $67,000 in order to have $100,000 *after* taxes to pay for the purchase price. If, however, a significant portion of the buy-in amount is characterized as some type of seniority payment or deferred compensation for the senior doctors, that amount would be paid by the practice to the senior doctors and reduce the physician's salary. The amount shifted to the senior physicians will be pretax money. This means that, for example, a physician buying in who pays $10,000 for the ownership and $90,000 as an income shift must earn only about $106,700 to pay the $100,000 buy-in amount ($90,000 plus $10,000 plus $6,700 in taxes) for a savings of about $60,300.

Action Step To maximize the pretax payment benefits rather than the post-tax payment detriments, physicians must analyze the allocation and tax treatment of the buy-in amount and the structure of the buy-in.

Mistake 4 **Excluding a Payment for the Existing Accounts Receivable in the Buy-in Amount**

When determining the value of the practice and the corresponding buy-in amount, if the practice requests the physician to "buy into" the accounts receivable, the physician should insist that such value exclude the accounts receivable that exist on the date of the buy-in. If included in the calculation of the value, the physician will pay for the accounts receivable with after-tax money and when the accounts receivable are collected by the practice and distributed to the physician as compensation, the physician will be taxed on it as ordinary income.

Action Step When structuring a buy-in, physicians should make sure that the accounts receivable are not calculated as part of the buy-in amount and, in lieu thereof, establish a mechanism whereby the existing physicians receive the value of the "good accounts receivable" over a period of time. Paying it over time will reduce any significant negative effect on cash flow and distribution.

Mistake 5 **Failing to Conduct Due Diligence Prior to Purchase**

As with all significant transactions, it is important that physicians conduct appropriate due diligence of the practice before finalizing the buy-in. Due diligence should include, at a minimum, a review: of practice documents (including its organizational documents); of the practice's financial statements and tax returns; of all material contracts to which the practice is a party; and of information regarding any potential or pending litigation; as well as such other due diligence that is reasonably necessary.

Action Step Physicians should spend appropriate time researching and reviewing the practice from an economic and legal perspective. They should receive appropriate representations and warranties regarding important issues, and the practice should indemnify them for damages resulting from past actions and any breach of a representation or warranty.

Mistake 6 **Having an Inappropriate Structure for the Entity**

Many physicians accept the organizational structure of the medical practice as it exists without asking questions and understanding the ramifications of different structures. The types of structures for a practice include a professional corporation, a partnership, and a limited liability company. It is important to understand the major differences among these entities and how they may affect the physician. Of critical concern is the ability to limit the physician's personal liability for the entity's liabilities and to maximize the tax advantages. Although all physicians are personally liable for their own malpractice liability, depending on the structure of the entity they may be able to insulate themselves from the medical malpractice of the other owners, as well as from the practice's obligations. When the practice is structured as a partnership, there is unlimited liability to the individual physician with regard to the other owners' malpractice and the general liabilities of the practice. In other

words, if the practice the physician is buying into is a partnership, the physician could "lose his or her house" if another owner does something inappropriate or has a malpractice judgment brought against him or her.

Action Step Physicians must review the structure of the practice to ensure that they are not creating additional unnecessary liability. If the entity is structured as a partnership (with unlimited liability), a physician should strongly recommend converting it to a limited liability company or a professional corporation to the extent it is allowed under state law. Physicians should avoid operating medical practices as partnerships.

Mistake 7 <u>Failing to Understand Related-Party Transactions</u>

Often, one or more of the existing owners may own the office in which the practice is located, may own the equipment used by the practice, or may provide services (e.g., billing or management) on behalf of the practice and receive compensation therefore. Also, the practice may employ an owner's spouse, children, or other relatives. It is important that a physician understand what these "related-party" transactions are and whether or not they are necessary and at fair market value. If they are not necessary or at fair market value, then they may have a negative effect on the physician's compensation. In addition, it is important to understand how patients are routed through the practice, especially if the physician's compensation is based on a productivity formula. For example, if the spouse of the senior physician is in charge of scheduling patients, it is very possible that that senior physician may be receiving the "most well-insured" patients, which will increase his or her productivity (and compensation) and, in turn, reduce the other physicians' productivity (and compensation).

Action Step Physicians should be sure that all related-party transactions are disclosed, are necessary, are at fair market value, and are documented. They should specify that patients are to be assigned equitably (based on procedures and payer mix) if compensation is based on productivity.

Mistake 8 <u>Failing to Understand Events That Trigger a Buyout of a Physician's Ownership Interest</u>

It is customary that, upon their admittance as an owner, physicians sign either a shareholder agreement or an operating agreement, which sets forth each physician's rights and obligations as an owner of the practice. These agreements typically set forth certain events that, when they occur, require the physician to sell his or her ownership interest in the practice to the other owners. A physician generally will be required to sell his or her ownership interest upon his or her death, disability (which must be clearly defined), and other termination of employment. There are also other events that require the sale of a physician's ownership interest which are not so obvious. Thus, all "triggering" events must be reviewed carefully to make sure that they are reasonable under the circumstances. For example, in some instances the physician may be terminated without cause by the other owners, requiring the physician

to sell his or her ownership interest in the practice. If this is the case, the physician should understand this and make sure the voting threshold for noncause termination is high. Certain other events, such as the failure to complete charts or a violation of a rule, should not trigger termination and result in a buyout without a notice-and-cure period. The nature of the triggering event may affect the buyout terms and/or the post-termination restrictive covenant.

Action Step Physicians should carefully review and understand the events that trigger a buyout.

Mistake 9 **Failing to Have Clearly Defined Termination Provisions**

In many practices, the agreements for terminating a physician's employment are not clear or provide that the practice may terminate the physician owner who has bought in without cause or with limited notice. Physicians must remember, however, that they may be wearing two hats in these situations: that of an owner who may want to terminate another owner or that of the physician who is being terminated. Typical termination provisions may include, at a minimum, material breach of the physician's employment agreement, loss of license to practice medicine, loss of DEA licensure, and loss of privileges.

Action Step Physicians should review termination provisions from both the employer's and the individual owner's perspective to make sure the provisions are fair and appropriate. They should make sure that the post-termination obligations appropriately fit the circumstances and have some relationship to the triggering event. Also, they should ensure that appropriate notice is given to allow a physician to attempt to remedy (cure) the breach before termination and the required sale of his or her ownership interests.

Mistake 10 **Failing to Understand the Restrictive Covenant**

In many states, restrictive covenants are enforceable if they are reasonable. Many employment arrangements contain restrictive covenants that prohibit a physician from practicing medicine for a specified time after termination and within a certain geographic area. Restrictive covenants also prohibit a physician from soliciting patients, referral sources, and employees after his or her employment is terminated. Such covenants will result in the physician's inability to continue to practice for a specific period of time within the local geographic area, which may include the community in which the physician lives. Each physician must understand the obligations (restrictions) that are imposed upon him or her at termination and make sure he or she can live with them.

Action Step Physicians must fully understand the restrictive covenants and the actions they prohibit. They should consider requesting the ability to "buy out" of the restrictive covenant on termination by waiving some or all of the money they are entitled to (the "buyout") upon their departure so that they can continue to practice in the community.

Conclusion
Before entering into negotiations regarding a buy-in to a medical practice, a physician should have a clear understanding of the issues that need to be addressed and should obtain appropriate professional advice. By avoiding and addressing the mistakes discussed in this section, physicians will find the post-buy-in relationship to have fewer surprises and disappointments.

About the Author
Michael F. Schaff, Esq., is a shareholder and head of the Corporate and Health Care Departments at Wilentz, Goldman & Spitzer PA, which maintains offices in New Jersey, New York, and Pennsylvania. Schaff has lectured extensively on health care matters across the country. He is the immediate past chair of the American Health Lawyers Association Physician Organization Practice Group, and a former chair of the New Jersey State Bar Association Health and Hospital Law Section. Schaff, who has published extensively on various health care topics, including physician representation, has a BA, joint JD/MBA (specialization in finance), and an LLM (in taxation). He is listed in *Best Lawyers of America* and is admitted to practice in New Jersey, New York, and Maryland. Schaff can be contacted by telephone at 732-855-6047 or by e-mail at Mschaff@Wilentz.com.

Peer reviewed by: Lisa Taylor, Esq., St. John & Wayne LLC, East Newark, N.J.; ldt@stjohnlaw.com.

4.7 The 10 Biggest Legal Mistakes Physicians Make When Negotiating Buy-ins–The New Partner's Perspective
By Patrick Formato, Esq.

Executive Summary
Unlike most professions, upon initial employment physicians want to know when and under what terms they will become an equity owner (typically referred to as partner) in the medical practice. In general, except for vague provisions outlining the parties' intentions, partnership is not addressed in an initial employment agreement. Physicians should use the time they serve as an employee to learn more about the practice and its partners. A partnership is akin to a marriage. Accordingly, physicians should learn as much as they can about their future partners before making a long-term commitment to become a partner in the practice.

Mistake 1 **<u>Starting Negotiations Too Late</u>**
Although new physician employees want to know from the outset when and under what terms they will become a partner, they often fail to negotiate terms in their employment agreement that will put them in a good position to negotiate their partnership buy-in. For example,