

The Financial Contract Every Practice Must Have...And Very Few Do

BY DAVID B. MANDELL, JD, MBA AND JASON M. O'DELL, MS, CWM

A dermatology practice owner, like all professional practice owners, should spend some of his/her time working ON the practice, not just IN the practice. We know this because we have our own professional practice ourselves. However, even if the owner works “on” the practice; if they ignore one fundamental legal contract, all of his/her work may be in jeopardy—as a single bad event could wipe out everything they have worked so hard to build.

When a physician dies, their family members will only get that doctor’s share of the outstanding accounts receivable, if that. Their family members will get nothing from a physician’s hard work in building the practice—as they typically can’t even own the medical practice shares and thus have no way to negotiate any buyout at all. If you’re concerned about this for your family, this contract is crucial.

Even if you’re not concerned about your family, what about the practice itself? Consider what would happen to the practice if a key partner becomes disabled—suddenly, the practice is a lot less profitable as it has the same expenses but less income because one partner can’t treat patients.

Unless these issues—and other important ones—are addressed in advance, financial havoc can ensue any time a partner dies, becomes disabled or even retires. The way to address these issues is through a properly funded buy-sell agreement.

BUY-SELL BASICS

There are various types of buy-sell agreements, which will be discussed below. Nonetheless, there are some basics regarding all buy-sell agreements that can apply to any type of business—specifically the benefit that different stakeholders can gain when one is in place. Buy-sells can be used for corporations (both S and C corporations), partnerships, limited partnerships, limited liability companies

“When a physician dies, their family members will only get that doctor’s share of the outstanding accounts receivable, if that. Their family members will get nothing from a physician’s hard work in building the practice—as they typically can’t even own the medical practice shares and thus have no way to negotiate any buyout at all.”

(LLC) and other forms as well. For these discussions, we will use the words “business owner” generically to mean any type of business owner (ie, shareholder in a corporation, partner in a partnership, member in a LLC, and so on).

A. Benefits to the business and remaining owners

From the standpoint of the business and remaining partners, a properly planned buy-sell agreement will provide the orderly continuation of the ownership and control of the business upon the happening of certain events, including:

- A death or disability of any owner
- The desire of any owner to sell his/her ownership share
- Divorce of any owner
- Bankruptcy of any owner, or other situation where creditors may have rights to ownership

The buy-sell agreement can prevent unwanted outsiders from becoming owners and eliminate the need for negotiation with surviving spouses and/or children. The agreement may also perform the role of a succession plan, providing for continuity or orderly succession of business management. Furthermore, as discussed below, the buy-sell agreement is often used in conjunction with life and disability insurance policies to effectively provide liquidity for the business to purchase outstanding ownership interests.

This in effect guarantees that the remaining owners will continue to control the business and be able to participate in the future growth of the business while also preventing a competitor from purchasing ownership interests from a retired, disabled or deceased owner, or their families. This guarantees continuity of management in the business, which makes the business more attractive to customers, creditors, and employees alike.

B. Benefits to each owner

From the standpoint of a living business owner, the agreement can provide the individual partner with an opportunity to negotiate and obtain the fairest and best price for his or her share of the business. Furthermore, in the case of retirement or disability, the agreement can be a source of additional funds for each owner.

C. Benefits to family members

For a deceased owner's family, the existence of the buy-sell can assure the family or estate a liquid asset rather than an interest in a private business. In a medical practice, physicians cannot leave it to their families unless they too are physicians, essentially not leaving their family any interest in the business. This is the only business that has this consequence. This is why a practice owner must have a buy-sell agreement in place with their partners clearly stating what each partner's family will receive from the surviving partner upon time of death or disability. This is fair and it is the right thing to do.

FUNDING THE AGREEMENT

Where the agreement contemplates a buy-sell transaction at the time of an owner's death or disability, insurance policies are generally recommended to fund the transaction. There are many reasons for this, including the following:

- Insurance policies pay a pre-determined amount, with proceeds available at exactly the time when they are needed as a funding source
- Proceeds will be available regardless of the financial state of the practice at that point (so long as premiums have been paid)

“If the payment contemplated under the agreement is not a lump sum cash payment at closing or is a periodic payment other than through a disability insurance policy, it is important to consider some type of security arrangement for the departing owner.”

- The business “leverages” the cost of premiums to create the proceeds; thus, it costs the business less to buy insurance than to save money in a special buy-out fund
- The economic risks of early death or premature disability of any owner are shifted to the insurer
- Insurance proceeds are paid to the family income-tax free
- If retirement is also a contemplated buy-out event, whole-life or universal-life policies can allow large cash values to accumulate, providing the retiring owner with a cash-out

If the payment contemplated under the agreement is not a lump sum cash payment at closing or is a periodic payment other than through a disability insurance policy, it is important to consider some type of security arrangement for the departing owner. These might include personal guarantee from remaining owners, mortgages or security interests in real estate, a bank standby letter of credit, or even collaterally assigned life insurance. The key here, of course, is what is negotiated upfront between the various owners—ideally—before there is an idea of who may die, be disabled, retire, or divorce first. This way, each owner will be unprejudiced in determining a fair buy-out.

Disability: The Overlooked Reason for the Buy-Sell

Buy-sell agreements receive a lot of attention when used to deal with the death of a business owner. However, something equally important and much more likely is that before any owner dies, he or she will become permanently disabled.

Business owners may need two-way protection in the event of disability. First, they have to consider providing for adequate income to meet routine personal expenses including increased medical expenses through a disability income program. Then, they must protect the value of their ownership interests, which can most easily be accomplished by expanding a buy-sell agreement to cover the risk of total disability.

An owner's disability may jeopardize the continued existence of the business. Similar to a death or retirement that has not been adequately provided for; the loss of a business owner due to total disability can create the following hardships:

- Impair credit standing and cause forced sale at a distressed price
- Necessitate sale to parties not compatible with the interests or philosophies of remaining management
- Reduce employee morale because the future of the business may be in doubt
- Cause economic hardships to the business if a totally and permanently disabled owner continues as an employee
- Create future problems if a totally disabled owner retains a decision-making position
- Impose adverse tax consequences

The Need for a Coordinated Team

Creating a buy-sell arrangement that fits a particular business requires expertise and experience. Expertise in areas of corporate and business law, tax law, insurance products, health care law and valuation are all absolute requirements. Just as important is experience in dealing with different owners and being able to negotiate and draft an agreement that meets the needs of all parties involved.

Too often, doctors make two key mistakes in deciding who should oversee the creation of a buy-sell arrangement. First, they chose their "lawyer friend" to create the strategy and draft the document rather than an expert in the area. Second, they do not have a coordinated team to implement the plan. Ideally, a coordinated buy-sell team would involve an attorney experienced in creating these arrangements and a life or disability insurance professional who has worked on these issues before—especially with first-to-die life insurance.

PLAN EARLY

As with any legal or insurance planning, the early bird is richly rewarded. No place is this more true than in buy-sell planning. The reason is not economic, but political. If this planning is done before an owner is close to disability, divorce, retirement or death, then all owners are in the same position relative to each other. That makes the negotiation of a standard deal for all owners a much easier and smoother process. On the other hand, if owners wait until one wants to retire, is very sick, or is about to get divorced, then these negotiations can be acrimonious. To avoid these problems, consider a buy-sell arrangement as soon as possible and begin the process with an experienced

advisory team. Physicians and their practice will be much better off for your efforts. ■

*To receive a free hardcopy of *For Doctors Only: A Guide to Working Less & Building More*, please call 877-656-4362. Visit www.ojmbookstore.com and enter promotional code PRDERM14 for a free ebook download of *For Doctors Only* or the shorter *For Doctors Only Highlights* for your Kindle or iPad.*

*Jason M. O'Dell, MS, CWM is a consultant, author of a number of books for doctors, including *For Doctors Only: A Guide to Working Less & Building More*, and principal of the financial consulting firm OJM Group www.ojmgroup.com, where Carole C. Foos, CPA, is a principal and tax consultant. They can be reached at 877-656-4362 or odell@ojmgroup.com.*



*David B. Mandell, JD, MBA, is a former attorney, consultant and author of five national books for doctors, including *For Doctors Only: A Guide to Working Less & Building More*, as well a number of state books. He is a principal of the financial consulting firm OJM Group www.ojmgroup.com along with Jason M. O'Dell, MS, CWM, who is also a principal and author. They can be reached at 877-656-4362 or mandell@ojmgroup.com.*



Disclosure: OJM Group, LLC ("OJM") is an SEC registered investment adviser with its principal place of business in the State of Ohio. OJM and its representatives are in compliance with the current notice filing and registration requirements imposed upon registered investment advisers by those states in which OJM maintains clients. OJM may only transact business in those states in which it is registered, or qualifies for an exemption or exclusion from registration requirements. For information pertaining to the registration status of OJM, please contact OJM or refer to the Investment Adviser Public Disclosure web site www.adviserinfo.sec.gov.

For additional information about OJM, including fees and services, send for our disclosure brochure as set forth on Form ADV using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

This article contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized legal or tax advice. There is no guarantee that the views and opinions expressed in this article will be appropriate for your particular circumstances. Tax law changes frequently, accordingly information presented herein is subject to change without notice. You should seek professional tax and legal advice before implementing any strategy discussed herein.