A sense of fair play and a carefully drawn buy-sell agreement can make the addition of a partnership-track associate a success for everyone involved.

Tying the PARTNERSHIP KNOT

Making It a Win for Both Practice and Associate

Jack Valancy, MBA

The addition of a new associate to a private practice, especially an associate on the partnership track, will not benefit either the new associate or the practice unless it benefits both. Success requires mutual trust and understanding, a long-term commitment on both sides and a sense of fair play all around. Given that, I hope this article, while addressed chiefly to the practice, will help both the practice and the prospective associate.

Physician-owners choose to add new partners to their practices for various reasons. (Although *partner* and *shareholder* are often used interchangeably, the former is accurate when the practice is legally organized as a partnership and the latter is accurate when the practice is organized as a corporation. In this article, I'll use *partner* to refer to either generically.) Physician-owners may want to share the work of a busy, growing practice, add specialized services, enter new markets, etc. Older physicians may be concerned with succession planning, including finding someone to buy their practice. (A similar set of considerations faces the prospective associate; see "Questions for the prospective associate to consider," a special feature of the online version of this article at http://www.aafp.org/fpm/20090300/23tyin.html.)

Can you afford to tie the knot?

A financially stable practice provides a firm foundation for adding an associate physician on the partnership track. To figure out whether your practice has the necessary stability, draft a hypothetical budget using realistic projections of the impact of a new associate. How much revenue might he or she generate? How much might it cost to employ a new physician, considering compensation and additional practice expenses? Do you expect your practice to break even on your new partner within the first year or two? Keep in mind that any shortfall must be covered by the current partners, practice reserves or

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Resist the urge to pay associates less than the going rate in exchange for a very low buy-in price.

outside financing. If the latter, you may wish to secure a line of credit from your bank or explore physician recruiting incentives from your hospital (see “Hospital physician recruiting incentives,” page 25).

What to look for in a prospective partner

You are looking for a physician who might enjoy private practice – specifically, *your* private practice. Look for an associate who might be willing to accept the benefits, risks and commitments of partnership.

Let each candidate know that he or she is interviewing for a partnership-track position – that you will offer the opportunity to become a partner in your practice if the new physician's time as an associate goes well. In addition to having the necessary training, skills and experience, does your prospective associate fit into your practice's culture? Does he or she find the practice's location and lifestyle attractive? Address such issues during the interview process. Invite your prospective colleague to shadow you during a typical day. Schedule time for the candidate and his or her family to explore your community both escorted and alone. Most important, assess whether your prospective colleague is prepared to make a commitment of five years or longer, provided that employment as an associate goes well.

Adding a partnership-track associate to a practice will benefit both or neither.

To accommodate a new associate, the practice needs financial stability.

The details of the offer should be clear to the associate and included in the employment agreement.

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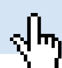
The offer

Tell each candidate what you are offering, and include the details in the associate physician's employment agreement. Would a new partner's compensation be calculated the same way as the other partners' compensation? Would he or she have an equal share and an equal voice in practice decisions? Would he or she have the opportunity to purchase shares of related business entities, such as the companies that own the practice's real estate or expensive equipment? These details should be spelled out in a buy-sell agreement, which I'll discuss later in this article.

When will the associate be eligible to become a partner? The typical partnership track is two or three years long, but you can set your own timetable. Are there explicit criteria for partnership, such as a productivity threshold? How much might partnership cost? You may state a specific amount or may indicate that the purchase price will be determined at the time of the buy-in. If the latter, explain how you will determine the practice's value and offer a realistic estimate. Also explain how you expect a new partner to pay for his or her share. (Here again, these issues should be addressed in the buy-sell agreement.)

Resist the urge to pay associates less than the going rate in exchange for a very low buy-in price, in effect requiring the associate to prepay the purchase price. Such “golden handcuff” arrangements may coerce an associate to accept your partnership offer, but a resentful, unhappy partner may do your practice more harm than good. By compensating your associates fairly for their work, you lay the foundation for productive, mutually beneficial long-term relationships.

As the eligibility date for becoming a


Article Web Address: http://www.aafp.org/fpm/20090300/23tyin.html

partner draws near, reassess whether you wish to offer your associate the opportunity to become a partner. Does he or she fit in with your practice's patients, physicians and staff? Does the practice have a patient panel large enough and referral channels strong enough to support all the physicians?

Analyze your practice's current financial status. Is the practice still sound enough to support a new partner? Examine your practice's income statements, balance sheets and tax returns for the past three years. Has the practice earned sufficient gross profits to adequately compensate the physicians? Does the practice have strong positive net worth? Do you anticipate any unusually large expenses? Develop realistic financial projections for the coming three years.

Buy-sell agreement issues

As the name implies, the buy-sell agreement (also called the partnership or shareholder agreement) describes the parties' relationship, including the terms and conditions for buying into and selling out of the practice. It defines the type(s) and number of shares available to physician-shareholders, their value and circumstances under which they may be bought and sold. A good agreement respects each party's interests; a poor agreement favors one party over the other. Offering equal partnership is a collegial long-term strategy. While offering a minority share or an inferior class of the practice's stock may increase your income and control, it can breed resentment that threatens the practice's culture, stability and financial performance.

Determining the partnership purchase price. The price of each physician's share of the practice should be calculated the same way for both buyers and sellers. Ideally, the share price reflects its value to both parties. The practice's *fair market value* is the price at which it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. By contrast, the practice's *investment value* is its value to a particular investor for particular investment objectives. Determining the practice's investment value, then, is a matter of perspective, that is, whether you are buying or selling shares. In the end, the price should reflect the benefits the practice and physician expect to receive from investing in each other.

The buy-sell agreement should contain a description of the medical practice, which includes both tangible and intangible assets. Tangible, or "hard," assets include furnishings, equipment, supplies, leasehold improvements to the office, real estate and financial resources (such as bank accounts, investments and accounts receivable). Intangible assets, which reduce to goodwill for a medical practice, represent the value of the practice as an ongoing concern, including the size and quality of the patient panel, referral sources and flow of new patients.

The practice's tangible assets may be valued in several ways. Appraised value relies on the expertise of a professional appraiser, who considers the age and condition of each item to estimate its market value. Although such appraisal is likely to be the most accurate methodology, many practices forgo it to avoid

HOSPITAL PHYSICIAN RECRUITING INCENTIVES

Hospitals often offer financial incentives for physicians to join a private medical practice. Although they are presented as income or collection "guarantees," Stark regulations require that these incentives be structured as loans.

If the newly recruited physician's monthly income after expenses during the one- to three-year support period is less than the "guaranteed amount," the hospital writes a check for the difference, thus increasing the physician's loan balance. In months when the physician's income is greater than the guaranteed amount, the excess is returned to the hospital, reducing the loan balance.

The repayment period begins when the support period ends, with two years of repayment typically allowed for each year of support. If the physician continues practicing in the area during the repayment period, the hospital forgives the monthly payment; if not, the physician must repay the balance of the loan.

While such financial incentives can be a win-win-win for the physician, practice and hospital, they can complicate matters if the relationship between the physician and practice sours. Recent revisions in the Stark regulations allow practices to impose limited restrictive covenants to prohibit a departing associate from practicing nearby.[1] When hospital incentives are involved, consider with extra care whether your new partnership-track associate is ready to make a long-term commitment to the practice and whether he or she will be able to build his or her practice sufficiently to earn adequate compensation after the hospital's financial incentives end.

the inconvenience and expense of retaining a qualified appraiser.

Book value is the amount the practice records for each item's cost minus its accumulated depreciation (estimated loss in value over time). While this method has the advantage of readily available figures on the practice's asset inventory and balance sheet, the use of accelerated depreciation for tax purposes may understate the assets' value.

One approach that has the merit of simplicity is to use a simple formula to approximate the value of tangible assets. For example, assume each asset has a useful life of 10 years; subtract 10 percent of the asset's cost for each year of age down to an estimated salvage value of 20 percent of cost. For example, if an office computer cost your practice $1,000 three years ago, its current value would be $700 and its value would never drop below $200.

The practice's intangible assets are much more difficult to value. Appraisers may approach the problem by projecting the difference between the present value of the practice's profits and the profits that might be expected from a hypothetical startup practice. Since these calculations can be complex and problematic, many buy-sell agreements use simple formulas, such as a percentage of collections or gross profits before physician compensation. For example, 10 percent of average collections of $360,000 per full-time equivalent physician estimates intangible assets of $36,000. Other buy-sell agreements just assign an arbitrary value to their practice's intangible assets.[2]

The practice's buy-sell agreement specifies how shares in the practice are to be bought and sold.

A good buy-sell agreement is fair to buyers and sellers and thorough enough to cover any eventuality.

Structuring the purchase. The buy-sell agreement also describes how the new partner will pay for his or her share and whether he or she will receive full shareholder rights immediately or whether the rights will accrue gradually as the purchase price is paid. In the latter case, the new partner's voting authority may be proportional to the amount he or she has paid toward buy-in. While it is common for new partners to pay for their shares by receiving reduced compensation over several years, some buy-sell agreements require the new partner to pay for all the shares immediately, often requiring him or her to take out a loan. The former approach is more collegial, while the latter can strain the practice's culture.

Accommodating senior partner preferences. Senior partners may include language in the new associate's employment agreement or the buy-sell agreement to protect their interests. While some preferences are reasonable, they should expire in five years or less so that new partners are assured of achieving equal status and rights within a reasonable period.

If you are one of your practice's founding physicians, you may wish to include language in the buy-sell agreement that protects you from being expelled from the practice and asserts your control by retaining veto power on business decisions. You may wish to include language allowing you to retain rights to the practice's name, telephone number and office location in the event that the partnership or corporation dissolves before you retire. This preference might continue in effect for, say, one to three years after the junior partners have fully paid for their shares. To handle the eventuality that the practice dissolves *after* this time, the buy-sell agreement may set prices the buyer(s) will pay the other partner(s) for their interest in each asset, or may state that prices will be negotiated at the time of the sale.

Senior partners may wish to enter a period of semi-retirement as a transition to full retirement.[3] If so, the buy-sell agreement should specify how they may reduce their regular and call schedules and how their compensation will be adjusted to reflect this. If the buy-sell agreement calculates the buy-out price based on annual compensation, it should use the figures from the retiring partner's last year of full-time

FPM ARTICLES RELEVANT TO TYING THE PARTNERSHIP KNOT

"Recruiting and Retaining the Right Physicians," Valancy J. October 2007:28-33; http://www.aafp.org/fpm/20071000/28recr.html.

"Finding the Perfect Job," Valancy J. July/August 2006:37-43; http://www.aafp.org/fpm/20060700/37find.html.

"How to Recruit New Residency Graduates," Giovino JM. March 2002:33-36; http://www.aafp.org/fpm/20020300/33howt.html.

"Choosing the Right Practice Entity." Sansweet JB. November/December 2005:42-44; http://www.aafp.org/fpm/20051100/42choo.html.

"Working Out Your Buy-In." Kalogredis B, Burke MR. October 1997:58-66.

"Fatal Organizational Flaws: Let the Physician Beware." Vogel DE. February 1997:28-37.

Buy-outs can be very costly to the remaining partners, especially when several physicians leave in a short period.

practice. To avoid unduly burdening the other physicians, the semi-retirement period should not be longer than two years, with extensions at the discretion of the full-time partners.

The buy-sell agreement should specify minimum performance requirements for a semi-retired physician to continue as an active partner in the practice. It may also include language designating retired physicians as *emeritus*. It honors the retired partner and helps the practice retain patients.

A junior partner may disrupt a senior partner's retirement plans by deciding to exercise his or her right to leave the practice. To mitigate this risk, the buy-sell agreement may specify that partners who leave the practice during another partner's declared semi-retirement period will receive a reduced buy-out price. Alternatively, in such a situation the partners may choose to liquidate the practice, with some of the physicians choosing to form a new practice.

Planning for buyouts. Just as the buy-sell agreement defines the methodology for valuing shares of partners buying into the practice, it also defines the buy-out methodology for physicians who leave for retirement or other reasons. The fairest approach is to use the same valuation methodology for buy-ins and buy-outs.

Buy-outs can be very costly to the remaining partners, especially when several physicians leave in a short period. To ease the transition, the buy-sell agreement may include language requiring departing partners to provide six to 12 months' notice of their departure or be penalized for inadequate notice. It may also limit payments to departing partners to no more than 5 percent of the practice's annual gross revenue, with interest accruing on the unpaid buy-out balance. (The prime rate plus 1 percent is a fair interest rate.) To fund the purchase of a partner's share if he or she dies or becomes permanently disabled, the practice may purchase life and disability insurance policies on the individual partners.

Competition from former partners can be collegial or corrosive. If the practice's culture is collegial, physicians may think nothing of allowing former partners to establish practices nearby. The buy-sell agreement might contain language permitting them to take the medical records of their patients. On the other hand, if the practice's culture is competitive, the partners may wish to include a non-compete provision to prevent former partners, including "retired" partners, from practicing medicine in the area.

One more eventuality that the buy-sell agreement should accommodate is the dissolution of the corporation or partnership. Typically, the agreement will specify that each partner is entitled to retain the medical records of patients he or she regularly treats. The practice should notify patients of their regular physician's new practice and tell those without a regular doctor how they can choose one.

Done wisely, the recruiting of a partnership-track associate can help a practice grow and thrive; done poorly, it can result in years of infighting, unhappiness and financial hardships. The keys are to choose new associates carefully, consider what's best for all involved before offering a partnership and craft a buy-sell agreement that is fair to all parties. Tie your partnership knot with care; don't let it become a hopeless tangle. FPM

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1. Gosfield AG. Stark III: Refinement, not revolution (part 2). *Fam Pract Manag.* April 2008:25-27. Available at: http://www.aafp.org/fpm/20080400/25star.html. Accessed Feb. 12, 2009.

2. For a slightly different approach to calculating the value of goodwill, see Practice valuation [Ask *FPM*]. *Fam Pract Manag.* October 2003:72. Available at: http://www.aafp.org/fpm/20031000/ask.html. Accessed Feb. 12, 2009.

3. Kalogredis V. It's not too early to plan for *semi*-retirement. *Fam Pract Manag.* February 2002:57-58. Available at: http://www.aafp.org/fpm/20020200/57itsn.html. Accessed Feb. 12, 2009.

The agreement needs to explain how shares are valued and how new partners will buy in.

It may include reasonable protection for the rights of senior partners.

Since buy-outs can be expensive, the agreement should specify how they will be handled under a variety of circumstances.