Newsletter Article Reprint

What if Something Happens: Is Your Practice Prepared for the Buy-Out of a Departing Owner?

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Dentists Joe Smith and Mary Brown practice together–until Smith has a disabling stroke. Brown is unable to buy Smith out or to pay Smith's share of the expenses. Smith has to sell, but is now at a negotiating disadvantage. The loss of a partner can throw any multi-owner or multi-practice relationship into a tailspin.

Protect Yourself With a Buy-Sell Agreement. The following are guidelines that buy-sell agreements should consider:

Events that Trigger a Buy-Out

The nature of the triggering event determines whether the buyer has an obligation or an option to purchase. An "involuntary" triggering event, such as when the owner dies, becomes disabled or reaches a predetermined retirement age typically mandates that the remaining owner buy-out the departing one. A "voluntary" triggering event, such as an owner's choosing to leave the practice or being terminated "for cause," typically gives the remaining owner an option to buy. The buy-sell agreement can also specify who buys whom out in the event of a dispute, thereby avoiding court battles.

The Purchase Price

A fair price for the departing owner's interest is usually established by a specific formula or appraisal. The purchase price may be adjusted by the triggering event (e.g., Brown pays less if Smith voluntarily quits or is fired for an inappropriate act).

The price must take into account tax laws. If Mary Brown purchases Joe Smith's stock in their professional corporation for $300,000, Brown gets no tax deduction for the stock purchase, which she pays for with after-tax dollars, while Smith receives a tax benefit by paying a relatively low (15%) capital gains tax on the stock sale. (This assumes that Smith owned the stock for over one year.) Fairness suggests: 1) lowering the purchase price to compensate for the negative tax effects on the buyer; or 2) structuring the arrangement to be more equitable, tax-wise, to both parties, assuming that the tax regulations are complied with (in our next issue, we will discuss ways to do this).

The Payment Terms

If payments are made in installments, spread them over a time period that balances the buyer's ability to pay with the seller's need for safety. The triggering event often influences the number of payments (e.g., Brown may pay Smith over a longer time if he voluntarily quits, as opposed to his becoming disabled).

In a buy-out involving installment payments, the IRS mandates that the seller charge interest. If you don't provide for interest, the IRS will "impute" (charge) part of your payment as interest. If seller Smith wants to keep buyer Brown's interest rate to a minimum, Brown could pay one or two points below the prime rate, but not less than the mandated amount, called the "Federal applicable rate."

When extending installment terms to the buyer, the seller can secure payment by: 1) having the debtor sign a promissory note guaranteeing payment corporately (or through the practice entity) and personally (and possibly also through another individual, as endorser); 2) holding the buyer's share of the stock in the professional corporation (or other entity) as collateral, and 3) restricting the buyer's ability to borrow money, take excessive compensation, participate in a merger, etc. until completing the buy-out.

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Using Insurance to Cover the Buy-Out

Life insurance (typically term life) and/or disability buy-out insurance can fund the buy-out should either of these triggering events occur. Disability buy-out insurance is cheaper and more prevalent than before. Be sure to distinguish disability buyout insurance from disability income replacement and overhead insurance, all of which are worth considering.

Review your practice's insurance coverage annually to be sure that it is: 1) sufficient, and 2) taken out by the right entity (e.g., Smith, Brown, and/or the professional corporation) on the right persons (Smith and/or Brown). The wrong party owning the insurance could have detrimental tax consequences. If senior partner Joe Smith is soon retiring, he may want life and disability buyout insurance on junior partner Mary Brown, because if Brown died or were disabled, Smith would have no one to buy his interest. Brown may also want this insurance on Smith to fund her buy-out if Smith died or became disabled.

Covenants on the Departing Owner

Buyer Brown may want to insure that seller Smith does not compete with her after she buys him out. This is done through non-compete and non-disclosure provisions in which departing Smith agrees not to practice for a specified time and within a specified distance from Brown's practice and not to disclose or use any practice trade secrets or other confidential information, such as patient lists or referral sources.

However, if Brown defaults on the payments to Smith, she would be subject to "mirror" restrictive covenant provisions, and Smith's non-compete would become null and void.

Dentists should meet with their accountant and lawyer annually to review the buy-sell and other agreements, revising them as needed. If you find your agreements are not comprehensive or need additional guidance, your ADS Florida transition specialist is another excellent resource.

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