

## Five Vital Elements of a Healthy Physician Buy/Sell Agreement

By Calvin Swartley, CFA, ASA  
Valuation Consultant  
Moss Adams LLP



Imagine if a shareholder in a physician practice could leave the practice while taking a share of the practice's revenue as well as his patient base with him. Or, if the newest and youngest shareholder is required to buy out the older shareholders all at once because they're free to leave the business with very short notice, and without having prepared for succession.

Both of these are real—and scary—scenarios that emphasize the importance of a strong, clearly written buy/sell agreement for physician practices. All practices, from a simple family practice to a complex group with several

specialties, need to spend time on these agreements so they can be used as guides during transitions or when issues arise. A clearly written buy/sell agreement helps mitigate uncertainty and increase liquidity, while allowing a company to continue operating without disruption during a time of transition. Nevertheless, problems, especially litigation, often arise as the result of disputes over these agreements, which can be ambiguous or lacking in structure.

These agreements often contemplate what might happen in the event of death or disability, but are less explicit about what happens when the partners no longer get along or when one of them decides to leave the business. These are common scenarios that could impact the overall value of a practice and the shareholders if not handled properly. In addition, practices also face the increasing pressure of declining reimbursements, higher costs being borne by their patients (who may not be able to pay them), increased operating expenses, industry consolidation, or today's complex regulatory environment. We've identified five critical components to focus on when

establishing or reviewing a buy/sell agreement, or basing an opinion of value on a company that has a buy/sell agreement:

1. Value definition
2. Purchase price standard
3. Silent or missing information
4. Shareholder involvement
5. Value interpretation

### 1. Value Definition

How do you determine the worth, or value, of your practice?

There are several standards of value in buy/sell agreements, which include fair market value, statutory definitions of fair value, and book value. Most physicians think that value is value. This is one reason business owners get upset with appraisers. With definition, the appraiser will know what standards to use in arriving at an opinion.

#### *Fair Market Value*

The standard of value typically considered the most appropriate is fair market value, which is defined as the dollar amount for which property would change hands between a willing buyer and a willing seller,

when the former isn't under any compulsion to buy, and the latter isn't under any compulsion to sell, and both parties having reasonable knowledge of relevant facts.

When you read this phrasing closely, you will recognize that in a real-life transaction, rarely do these conditions exist. Fair market value, then, is a hypothetical notion of value promulgated by the IRS for gift and estate tax purposes, but often used as a general guideline in such agreements.

### *Fair Value*

Fair value, on the other hand, is usually a legally-created standard of value based on statutes and case law, which applies in dissenting shareholder disputes. Fair value is the value of shares immediately prior to an event to which a shareholder objects. The difficulty with fair value is that its interpretation and definition aren't consistent across state jurisdictions.

### *Book Value*

Book value is a term that's often used. It's simply the equity on the balance sheet of the company at any date in time, while net book value is the company's total assets minus total liabilities.

Book value, or net book value, is easy to calculate and easy to explain. However, it may not provide a good indication of the company on a going concern basis. Further, book value can be manipulated to create a low value. It's an especially irrelevant basis for value in a physician practice because it can in no way account for goodwill or the intangible value of the practice, if it exists.

### *Other Valuations*

Formula pricing, which uses a simple calculation, is also used in some buy/sell agreements. A formula pricing method is usually objective and inexpensive, but as with book value it often doesn't represent fair market value. A buy/sell agreement that includes a formula pricing method should be reviewed periodically to ensure the formula meets the changes the company incurs.

In the health care industry, there's a separate definition that has come out of the regulatory requirements of Stark law, which is based on an arms-length transaction and is consistent with the general market value. Stark law defines general market value by considering the price that's the result of bona fide bargaining between well-informed buyers and sellers. It also states that these parties must not otherwise be in a position to generate business for the other party.

Inevitably, when a business owner feels that their business has been valued too low, they point to what they understand to be real-life market prices with strategic or financial buyers. Such transactions can contemplate the benefit of synergy whereas internal transactions cannot (this could also include operational cost savings or even discretionary expenses). So it isn't uncommon to see buy/sell agreement valuations that are much lower than what's found in the open market.

## **2. Purchase Price Standard**

How will your purchase price be determined?

Defining the purchase price standard plays an important role in a buy/sell agreement. The total equity value of a company (or controlling value) is significantly different from a minority, noncontrolling interest in a company.

The absence of defining the purchase price creates the possibility that a shareholder is entitled to something different than fair market value. For instance, a buy/sell agreement that states the price to be paid in the event of a transaction is the fair market value of the company could be interpreted to mean that the price per share for a minority shareholder is the same price per share for a controlling shareholder.

The purchase price standard should also include clear provisions for adjustments—whether they should be made for lack of control, lack of marketability, or key person discounts, for example.

These types of provisions are especially acute in health care buy/sell agreements. The selling shareholder or injured party in these transactions often points to real-life market prices from the sale of entire practices as benchmarks. But if a shareholder is giving up a noncontrolling stake (less than 51 percent in most states), then shouldn't the price be determined on a noncontrolling basis?

When drafting or revising your agreements, each physician should consider both sides of the transaction. It's one thing to structure the agreement to a higher value assuming you're the first one out the door, but what if you aren't? Or what if you have multiple shareholders who all decide to leave

at the same time without warning, leaving you holding the bag?

### **3. Silent or Missing Information**

Has your agreement covered all of the potential triggering events?

Buy/sell agreements are often silent on items or fail to consider all potential issues that may arise. For example, if the standard of value is missing, it may be the judge, mediator, state law, or even case law that will set a standard. To resolve silent or missing information, an expert is required to rely on state law, guidance from the company's counsel, and experience to resolve these problems.

A good buy/sell agreement includes a determination of the effective date of a triggering event, such as an attempted sale or transfer, retirement, termination (voluntary and involuntary), death or disability, or divorce of the shareholder. Without a clear determination of the effective date, a moving target could be created, making resolution even harder.

An incomplete buy/sell agreement becomes especially aggravating to the departing shareholder. In many cases, hostility has developed long before the buy/sell agreement can be triggered. If the fight goes on for months or years, the practice itself could suffer from all the distractions, thereby causing its overall value to go down.

### **4. Shareholder Involvement**

Does your agreement address the annual review of value?

Some buy/sell agreements state that

the shareholders will determine the value of the shares on an annual basis (or some other time period). The intention of this type of language is to involve shareholders in the process of determining value and to lay the foundation for smooth transitions when they occur.

Annual determinations are considered very beneficial and can help physician practices examine what isn't working, and to build upon what is working. However, if there's little discipline in having management meetings, or addressing these issues, you may create a big problem down the road when the buy/sell agreement is triggered. If a dispute arises without an annual valuation in place, the chance of the parties agreeing on a value is very low, and the dispute may require outside determination or resolution.

### **5. Value Interpretation**

How will the value of your practice be defined in a dispute?

In a dispute over value, a judgment will be made on the value of the company or a specific block of shares in the dispute. Although the buy/sell agreement is established to set a precedent, it may be given little weight or ignored in making a final determination. The courts have shown a dislike for book value in certain circumstances. Further, attempts to buy-out shareholders prior to a purchase of the company have been shown to be a breach of fiduciary duty.

Determining the value of the practice or its shares is a key item for a buy-sell. Valuation of a closely held company or practice is too difficult

for the court to determine, and valuation specialists are typically called in to assist. These specialists usually rely on a combination of appraisal methods to determine the value of a company or portion thereof. In some instances, the valuation process can be highly complex and expensive.

#### *The Valuation Process*

In some situations the opposing parties hire one specialist, and accept whatever value the specialist determines. However, this is rare.

Typically, anywhere from one to three valuations are performed, and many valuation specialists weigh in on a final value. For example, one specialist performs an appraisal, which is then critiqued by specialists hired by each side. Or, each party hires a specialist, while a third makes the ultimate decision from the facts presented by the two valuations.

In either case, the cost to complete the appraisal can quickly escalate. Clearly defining the "who" and "how" for the valuation of the company in the buy/sell agreement will greatly decrease the uncertainty of valuation when one is needed.

#### *Appraisal Firms*

There are several reputable business valuation or appraisal standards organizations, including Accredited Senior Appraiser (ASA) from the American Society of Appraiser and AICPA Accredited Business Valuation Analyst (ABV). When selecting or designating appraisers for your agreement, you may look to these groups for names of qualified experts. If you aren't acquainted

with them, you might interview them and ask for background.

Firms who do appraisals of health care entities should demonstrate an understanding of your business and the industry, and describe for you their comprehensive process that will consider the earnings capacity of your business, market pricing, and comparable pricing analysis.

#### *Published Data*

Investment bankers specializing in health care often publish data on mergers and acquisitions of larger health care entities. There are also proprietary merger and acquisition sources that provide data on business transactions, though the data is often limited. Even with these excellent resources, it's very difficult to get solid comparable pricing because of the size, nature of the practice, and terms of the transactions aren't always fully disclosed.

#### **The Bottom Line**

Do your practice a favor and check on the health of your current agreements. As practices get larger, and more individuals are either promoted to partner or shareholder in the practice, or merged in, the need to establish an agreement increases with clear instructions for those who must interpret them.

Without careful planning, the intent of the buy/sell agreement could be lost and battled out in court, which is expensive and potentially debilitating to your practice. Even though the best written buy/sell agreement can't guarantee a smooth transition, defining the key aspects of a buy/sell agreement and including all pertinent information will lessen the uncertainty during a transition.

These agreements will likely be more detailed as the health care

industry continues to evolve, and attorneys become more familiar with the unique challenges facing practices with more providers or affiliations. In the meantime, it is helpful for physician groups themselves to begin recognizing what questions to ask of their counsel before entering into such agreements with their partners.

*Calvin Swartley provides valuation consulting for physician practices, including business succession, purchase or sale, buy/sell agreement requirements, and shareholder disputes. He has worked with operating companies, limited partnerships, limited liability companies, as well as valuing preferred stock, options, and intangible assets. You can reach him at (503) 471-1294 or calvin.swartley@mossadams.com.*

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