

THE FINANCIAL CONTRACT YOU ARE PROBABLY MISSING

Buy-sell agreements can help protect practice assets.

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Savvy ophthalmology practice owners know they need to work on the practice, not just in it, but many of those owners are putting all of their work in jeopardy by missing one fundamental legal contract. Financial havoc can

ensue when a partner dies, becomes disabled, or even retires. The way to address these issues is through a properly funded buy-sell agreement.

WHY YOU NEED IT

When a physician dies, his or her family members will only get that doctor's share of the outstanding accounts receivable, if that. The family members will get nothing from a physician's hard work in building the practice; they typically cannot even own the medical practice shares and have no way to negotiate a buyout. If you are concerned about this for your family, this contract is crucial. Beyond family concerns, consider the practice itself. What would happen if a key partner became disabled? Expenses would stay the same, but with one partner no longer able to treat patients, income would drop.

A buy-sell agreement is vital to preparing for events like these. There are various types of buy-sell agreements that can be used for S and C corporations, partnerships, limited partnerships, limited liability companies, and more. For these discussions, we will use the words "business owner" generically to mean any type of business owner (eg, shareholder in a corporation, partner in a partnership, member in a limited liability company).

BENEFITS TO THE BUSINESS

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 occurrence of a death, disability, divorce, or bankruptcy of any owner or the desire of any owner to sell his or her ownership share.

The buy-sell agreement can prevent unwanted stress to the practice, as litigation can result from the family of

deceased physicians if no agreement is in place. In essence, the buy-sell agreement performs the role of a succession plan, providing for continuity or orderly succession of business management.

Furthermore, as will be discussed, the buy-sell agreement is often used in conjunction with life and disability insurance policies to provide liquidity for the business to purchase outstanding ownership interests. This effectively guarantees that the remaining owners will continue to control the business and be able to participate in its future growth. It also prevents a competitor from purchasing ownership interests from retired, disabled, or deceased owners or their families. Continuity of management makes the business more attractive to customers, creditors, and employees alike.

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.

BENEFITS TO FAMILY MEMBERS

For a deceased owner's family, the existence of the buy-sell agreement can ensure the family or estate ownership of a liquid asset rather than an interest in a private business. Physicians cannot leave a medical practice to their families unless the family members are also physicians, essentially leaving their families without any interest in the business. This is the only type of business that has this consequence. That is why practice owners must have a buy-sell agreement in place with their partners clearly stating what each partner's family will receive from the surviving partner(s) in the event of a death or disability. This is fair, and it is the right thing to do.

FUNDING THE AGREEMENT

When the agreement addresses 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. Insurance policies pay a predetermined 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, as long as premiums have been paid. 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 buyout 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 free of income taxes. If retirement is also a contemplated buyout 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. This might include personal guarantees 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 that these details are negotiated upfront among 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 buyout.

DISABILITY

Buy-sell agreements receive a lot of attention when they are used to deal with the death of a business owner, but something equally important and much more likely is that an owner may 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 because of 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 is an absolute requirement. Just as important is experience 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

AT A GLANCE

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- As with any legal or insurance planning, the early bird is richly rewarded. Nowhere 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.

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. Nowhere 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. You and your practice will be much better off for your efforts. ■

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