Ophthalmology Buy-In and Pay-Out Arrangements

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* Financial Interest

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- Shareholders of and Consultants with The Health Care Group, Inc. and Health Care Consulting, Inc.
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Who We Are

- Business and legal advisors to ophthalmologists and other physicians
- Handle and advise re: new doctor employment agreements, buy-ins, pay-outs, practice sales, valuations, income division arrangements, etc.
- Publishers of the Goodwill Registry, used in ophthalmology and other medical practice valuation

Buy-in Planning

- Plan ideally begins prior to first employment agreement
- Set expectations, outline terms
- But, no promises
- Critical evaluation, feedback, notice of problems
- Firing associates vs. divorcing a partner

More Than a Buy-in

- Four things happening simultaneously
  - Buy-in
  - Governance / Decision Making
  - Income Division
  - Pay-out
Formal Valuation of Practice?

- Not strictly necessary
- Review financials
- Ball park values usually involved
- Evaluate financial feasibility

Method and Structure for the Buy-in

- For the ease of understanding and illustration, assume the practice entity is a professional corporation
- But, the same basic principles apply to other types of practice entities

Method and Structure for the Buy-in

- Two part process
  - Stock purchase (equipment)
  - Income discounting (accounts receivable and goodwill)
Method and Structure for the Buy-in

- Tax considerations
  - Capital Gains vs. Ordinary Income
  - Financial affordability issue

Values Involved in the Buy-in

- The "big three"
  - "Hard assets" (equipment, other tangible assets)
  - Accounts receivable
  - Goodwill

"Hard Assets"

- Modified net book value
  - Eliminate assets no longer in use
  - Section 179 assets
  - Restate depreciation
    - Straight-line depreciation over 8 - 12 years
    - 20% floor
"Hard Assets"

- Modified net book value, continued
  - Capitalized (non-operating) leases
  - Exclude personal items (automobiles, artwork, etc.)
  - Possible appraisal of "major" ophthalmic equipment

"Hard Assets"

- Modified net book value
- Less debt and other liabilities
- Example

MODIFIED NET BOOK VALUE

<table>
<thead>
<tr>
<th></th>
<th>Book Value</th>
<th>Modified Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Hard Assets</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: Accumulated Depreciation</td>
<td>$0</td>
<td>$50,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$10,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Equity</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total Liabilities and Equity</td>
<td>$10,000</td>
<td>$80,000</td>
</tr>
</tbody>
</table>
Other Values

- Inventories / Supplies
- Leasehold interests and improvements
- Contractual arrangements

Accounts Receivable

- Include associate's accounts receivable?
- As of when?
- How to value them?
- Example

ACCOUNTS RECEIVABLE

THE EYE CENTER GROUP, PC

Accounts Receivable (A/R) as of 12/31/2015: $230,000

- Minus A/R More Than 150 Days Old: ($5,000)
- Adjusted Gross A/R as of 12/31/2015: $225,000

Multiply by Gross Collection Percentage (from below): $225,000 x 90.0% = $202,500

Net Accounts Receivable as of 12/31/2015: $202,500

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Collections (12 months)</th>
<th>Gross Collections Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$2,500,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>2014</td>
<td>$2,000,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>2013</td>
<td>$1,500,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>2012</td>
<td>$1,000,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>2011</td>
<td>$500,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>2010</td>
<td>$0</td>
<td>50.0%</td>
</tr>
</tbody>
</table>

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Goodwill Value

- What is it? Does it exist?
- Date of valuation
- Include associate’s revenue?
- Guidelines for ophthalmology

<table>
<thead>
<tr>
<th>Year(s)</th>
<th>Goodwill %</th>
<th>Average Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005 – 2014</td>
<td>76.72%</td>
<td>16 Year Average</td>
</tr>
<tr>
<td>2010 – 2014</td>
<td>77.20%</td>
<td>5 Year Average</td>
</tr>
<tr>
<td>2011 – 2014</td>
<td>77.25%</td>
<td>4 Year Average</td>
</tr>
<tr>
<td>2012 – 2014</td>
<td>77.41%</td>
<td>3 Year Average</td>
</tr>
<tr>
<td>2013 – 2014</td>
<td>28.98%</td>
<td>2 Year Average</td>
</tr>
<tr>
<td>2006</td>
<td>22.16%</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>22.16%</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>29.63%</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>29.63%</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>29.63%</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>29.63%</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>29.63%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>29.63%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>29.63%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Goodwill Registry 2015
Co-ownership

- 51%/49%? 50/50?
  - Financial issues
  - Control issues
  - Psychological issues
- Equal ownership, with senior doctor protection
- What impact on compensation?
The Stock Purchase

- Equal stock at once?
- "Hard assets" value only
- Measure as of year-end / month-end
- Spread payment over time with interest
  - Down payment
  - Interest rate

Senior Partner's Protection - Stock Option

- Trade-off for (early) equal ownership
- Limited time period
- Is it fair to the associate?
- Is it fair to the practice not to have it?
- Are there alternatives?

Income Discounting

Defining "net income"
- Salary and bonuses
- Retirement contributions
- Fringe benefits
- "Semi-personal" business expenses
- Practice profit or loss
Income Discounting

Defining "net income"

- Examples

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DEFINITION OF NET INCOME

<table>
<thead>
<tr>
<th>From Tax Return or Income Statement</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income (Total Collections)</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Less: All Expenses (including Physician Salaries, Retirement Plan Contributions and Benefits)</td>
<td>($1,200,000)</td>
</tr>
<tr>
<td>Net Profit (Loss)</td>
<td>0</td>
</tr>
</tbody>
</table>

---

Income Discounting

- Two ways to "discount"
  - Exact method
  - Inexact method
- How should the discount be reallocated among the other practice owners?
- Viability in a changing health care environment
### Income Discounting

**Inexact Method**

- **Examples**

<table>
<thead>
<tr>
<th>Senior</th>
<th>Junior</th>
<th>Discount</th>
<th>Senior</th>
<th>Junior</th>
</tr>
</thead>
<tbody>
<tr>
<td>$300,000</td>
<td>$300,000</td>
<td>40%</td>
<td>$420,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>$300,000</td>
<td>$300,000</td>
<td>30%</td>
<td>$390,000</td>
<td>$210,000</td>
</tr>
<tr>
<td>$300,000</td>
<td>$300,000</td>
<td>20%</td>
<td>$360,000</td>
<td>$240,000</td>
</tr>
<tr>
<td>$300,000</td>
<td>$300,000</td>
<td>10%</td>
<td>$330,000</td>
<td>$270,000</td>
</tr>
<tr>
<td>$300,000</td>
<td>$300,000</td>
<td>0%</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>
### INEXACT (60-70-80-90)

#### Income Discounting Adjustment Schedule:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
<th>Productivity Income</th>
<th>Total Income</th>
<th>Discount Adjusted Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2017</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2018</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2019</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2020</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

**Total Discount:** $300,000

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### INEXACT (75-75-75-75)

#### Income Discounting Adjustment Schedule:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
<th>Productivity Income</th>
<th>Total Income</th>
<th>Discount Adjusted Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2017</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2018</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2019</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2020</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

**Total Discount:** $300,000

---

### INEXACT (75-75-75-75)

#### Income Discounting Adjustment Schedule:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
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<th>Discount Adjusted Income</th>
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</thead>
<tbody>
<tr>
<td>2016</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2017</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
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<tr>
<td>2018</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
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<tr>
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<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2020</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

**Total Discount:** $300,000
Pay-out Planning

- Planning ideally begins prior to the time of the first owner's departure
- Agreements should be entered into prior to the time of the first owner's departure
- Pay-out arrangements should be done in conjunction with an associate's buy-in
Pay-out Planning

- Remember, there were four things happening simultaneously in a buy-in
  - Buy-in
  - Governance / Decision Making
  - Income Division
  - Pay-out

Formal Valuation of Practice?

- Not strictly necessary
- Review financials
- Ball park values usually involved
- Evaluate financial feasibility

Method and Structure for the Pay-out

- Two part process
  - Stock repurchase / redemption (equipment)
  - "Separation Pay" / Deferred Compensation (accounts receivable and goodwill)
## Method and Structure for the Pay-out

- Tax considerations
  - Capital Gains vs. Ordinary Income
  - Tax deductible or not
  - Financial affordability issue

## Practice Valuation Upon Departure

- Same assets and valuation as for the buy-in
  - "Hard assets"
  - Accounts receivable
  - Goodwill
  - Other values
  - Reluctance of partners to recognize goodwill

## Stock Repurchase / Redemption

- Payments over time with interest
  - Down payment
  - Minimum payments
  - Interest rate
  - Tax treatment
"Separation Pay" / Deferred Compensation

- Deciding on the pay-out amount
- Accounts receivable
- Goodwill value of ongoing group

"Separation Pay" / Deferred Compensation

- Deciding on the pay-out amount
- Year’s “net income” principle
- Example
- Spread out over a number of years
- Tax treatment and issues

INEXACT (75-75-75-75)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DEC. SR. EQUAL INCOME</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>PRODUCTIVITY INCOME</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ADJ. DISCOUNT ADJUSTMENT</td>
<td>75,000</td>
<td>75,000</td>
<td>75,000</td>
<td>75,000</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>TOTAL NET INCOME SHARE</td>
<td>575,000</td>
<td>575,000</td>
<td>575,000</td>
<td>575,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>DEC. JUNIOR EQUAL INCOME</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>PRODUCTIVITY INCOME</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ADJ. DISCOUNT ADJUSTMENT</td>
<td>(75,000)</td>
<td>(75,000)</td>
<td>(75,000)</td>
<td>(75,000)</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>TOTAL NET INCOME SHARE</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>$225,000</td>
<td>$225,000</td>
<td>$225,000</td>
</tr>
</tbody>
</table>

TOTAL DISCOUNT: $200,000
Funding a Pay-out

- Use of insurance
  - Life
  - Disability
- Create corporate reserves?
- Funding from ongoing earning capacity
- Ongoing partners’ personal guarantees?

Limitations to Protect Ongoing Group

- Reduction if compete / solicit patients
  - Logical necessity
  - How broadly to define the restrictive covenant?
  - Reduce all, or only the goodwill portion?
  - Recoup amounts previously paid?

Limitations to Protect Ongoing Group

- Reduction for short notice given for voluntary termination of employment
- Reduction for sick pay previously received
- Reduction for “bad behavior”
Limitations to Protect Ongoing Group

- Reduction if group's income decreases
  - Gross Income versus Net Income
  - Philosophical question if proper
  - Should reduction extend the payments?
    - If so, how long of an extension?
    - Indefinitely, until paid?
  - Multiple pay-outs at the same time

Limitations to Protect Ongoing Group

- Reduction for post-separation benefits
  - Malpractice insurance
  - Health, disability, and life insurance
  - Other benefits

Limitations to Protect Ongoing Group

- Reduction for post-separation liabilities
  - Malpractice, tax, third party repayment obligations, etc.
  - Eliminate remaining "separation pay" / deferred compensation or attempt to recoup all
Miscellaneous Pay-out Issues

• Senior doctor's pay-out
  • Senior doctor's own pay-out, plus
  • Remainder of associate's buy-in

• Phase up of associate's entitlement to a pay-out
  • Phase up directly proportional as the buy-in is completed?
  • Longer phase up?

QUESTIONS?
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