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## Buy-in and Buy-out of Shareholders in Professional Groups

Professionals come and go from practice groups.  When a professional enters a practice group as a shareholder or partner, the group should prepare for his or her exit.  The exit is inevitable.  In this article, I give one simple rule for structuring the professional's buy-in to a practice and the later buy-out of his or her shares from the practice.

- [Professionals are doctors, accountants etc. -- I'll just call them "doctor" in this article.]

**The Rule.**  Buy-in should mirror buy-out.  If a doctor buys-in to a practice at $X, the practice should buy-out the doctor at the same $X.  In other words, you should use the same formula to determine both a doctor's purchase price for shares in a practice, and the doctor's buy-out price when leaving the practice.  The reason for the rule is fairness.  Neither the practice nor the doctor should get a windfall from the buy-in and subsequent buy-out.

Founders are the primary exception to the rule.  Founders usually get a special deal because they built the practice and made it valuable.  In the start-up years, a founder's compensation is low and he suffers higher risk, so it's fair for the founder to receive the full buy-back price later on.

**The Purchase Price for Buy-in and Buy-out.**  The buy-in & buy-out prices (when taken together) can be high (e.g. $100,000-in and $100,000-out), or they can be low ($10-in and $10-out), depending on the practice.  In most practices, the price is either a formula that approximates fair market value (FMV), or an arbitrary or nominal number.

I've seen many different buy-in and buy-out prices.  I've seen one practice with a nominal price of $10 for both buy-in and buy-out, and what's more, the structure worked!  Most practices, however, base the price on FMV.  An FMV buy-in / buy-out price will equal the percentage share of the practice to be bought or sold, multiplied times the value of the practice.

You determine the value of the practice based on 3 factors – tangible assets, accounts receivable, and goodwill. You can determine tangible assets and accounts receivable without much debate, because they represent hard assets that exist in the here and now.  Goodwill is much harder to fix.  Goodwill is the value of the practice's expected *future* earning power, and the future is unknown.  Goodwill varies from practice to practice.  Although you can spend thousands of dollars on a fancy practice valuation and appraisal, ultimately you make a gut call on the value of goodwill.

**Payment Terms.** The doctor can pay the buy-in price, and the practice can pay the buy-out price, in cash or in installments. If a doctor pays for shares in cash, the doctor should receive the buy-out in cash (to the extent that practice liquidity permits this). Likewise a doctor who buys-in to the group over time using installment payments (e.g. a promissory note or salary reduction) should receive a buy-out in installments (e.g. a note or deferred compensation).

Many practices pay the buy-out price as a combination of the buy-back of shares and deferred compensation. They do so for tax reasons because deferred compensation is deductible to the practice and taxable to the doctor as ordinary income. Deferred compensation can be useful if a doctor paid the buy-in through reduced salary (which are pre-tax dollars for the doctor). At buy-out, the practice gets to deduct the deferred compensation, which evens out the tax benefit.

If the practice pays a part of the buy-out price through a promissory note, the maturity of the note should be long enough that it does not overburden the practice yet short enough so the departing doctor does not wait too long for closure (e.g. 2-4 years).

**Competition After Buy-out.** A California practice can impose a non-competition clause on the departing doctor. In California, a non-competition clause is legal if it occurs as part of a bona-fide buy-back of the doctor’s shares. Some practices take very seriously the threat of competition, but other practices don’t really care. It depends on the nature of the practice and the market.

If a practice does not demand a non-competition clause, it should at least regulate the process by which the departing doctor leaves. The practice should control how the doctor communicates with referral sources, employees and clients / patients. The practice needs an orderly and professional process for separating the doctor from the practice. You don’t want either side (whether the departing doctor or the professional group) to poison the other’s well.

**Corporate Documents.** The practice’s corporate documents should state the terms of the buy-in and the buy-out. Ordinarily you cover the buy-in in a Purchase Agreement, and the buy-out in a Shareholders Agreement.

You need an experienced attorney to implement my rule for buy-ins & buy-outs. Do not do this alone because there are many considerations and choices that I don’t have time to cover in this short article. Call me if you want to talk more.

“I see it, but it scampers away from the light.”