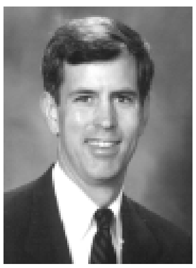
Business Valuation Review

Do Professional Practice Buy-Sell Agreements Represent Fair Market Value?

By: George B. Hawkins, ASA, CFA

Deposition of Dr. Jones (A Divorcing Orthopedic Surgeon): *"I only paid $1,000 to buy my shares in my buy-in to the medical practice and I am only paid $1,000 for my shares if I leave. It's simple- that's the value of my shares, not the much higher amount determined by my ex-wife's business appraiser."*



George Hawkins

A Common Refrain. I wish I could count the number of times I have heard a similar refrain from a professional (e.g., physicians, lawyers, accountants, architects, etc.) in an equitable distribution matter. Does this statement have merit? Is the buy-in price or a price that is paid the departing professional under a shareholder agreement indicative of the fair market value of his or her shares for equitable distribution purposes?

First, let's admit that every buy-in and buy-sell arrangement is unique and must be examined on the basis of its own merits and terms and the specifics of the practice at issue. Therefore, it is not possible to give a generalized answer in this article that will apply to all situations. However, having just admitted that one cannot generalize, I am going to violate my own statement and make a bold prediction based on experience:

> **Equitable Distribution Valuation Generalism- Professional Practices-** In many cases involving a professional practice, the stated price for the buy-in and the buy-out of a shareholder, taken solely on its face, without considering other elements, often significantly understates the "true" price paid for the practice interest at issue.

Don't rush to the conclusion that I am taking the anti-professional spouse position and am seeking equitable distribution valuations from the non-practicing spouse by making this statement. This statement simply reflects simple facts that are often overlooked in the valuation process by the business appraisers and attorneys involved, but which should at least reasonably be considered in preparing an unbiased business valuation. This article will explain why. Also, in some circumstances, the total implied value of a buy-in or buy-out may provide powerful evidence in an unbiased manner that the higher or lower values estimated by other valuation methods or other business appraisers are unreasonable.

A Hypothetical Buy-In Example: Let's consider a typical example of a buy-in arrangement that is fairly common in a professional practice situation and see why appearances can be misleading about the total implied value of the buy-in. Assume that Dr. Jones, an orthopedic surgeon, joined a practice as an employee on January 1, 1997 and became a shareholder on January 1, 2000. Dr. Jones separated from his wife on January 1, 2003 and is now pointing to the $1,000 price he paid on January 1, 2000 as a direct indication of the value of his shares.

After graduation from medical school and the completion of a residency and then subsequent fellowship, Dr. Jones became board certified in orthopedic surgery and was now ready to begin the full time practice of his specialty. On January 1, 1997, Dr. Jones goes to work as an employee of Orthopedic Surgery, P.A. ("Practice"), a successful seven-physician practice providing orthopedic surgery services.

The buy-in deal was structured as follows: Dr. Jones would start work at the Practice on January 1, 1997, where he would work as an employee physician for three years. Unless he proved to be professionally incompetent or incompatible with the exist-

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ing physicians, Dr. Jones was told he would be offered the chance to buy-in as a shareholder after three years, enabling him to purchase shares on January 1, 2000. At that time, he would buy a one-eighth interest (or a 12.5% minority interest) in the Practice for a cash payment of $1,000. During his three years as an employee physician, Dr. Jones would be paid $200,000 in annual salary, or $125,000 less than the shareholder physicians in the Practice, each of whom earned $325,000 per year.

A Hidden Buy-In Cost is Being Paid. Is the total implied buy-in price paid by Dr. Jones really $1,000, or is it something else? In this instance, as is often the case, the total implied price paid to become a shareholder is not simply the price paid for one's shares. The new orthopedic surgeon (Dr. Jones) is expected to work for a reduced salary for three years. Only after becoming a full shareholder in year four will Dr. Jones be compensated at a full salary equal to the other shareholders. Dr. Jones is paying a hidden, implied cost for the buy-in in the form of accepting reduced compensation until he becomes a shareholder at the beginning of the fourth year. Therefore, the total implied value (subject to some later caveats) of the cost of a buy-in is the sum total of the present value of the foregone compensation during the period as an employee physician, plus the $1,000 price actually paid for the shares at the point of the buy-in.

Hidden Buy-In Costs Are Common For Most Types of Professional Practices. This type of arrangement is not unique to medical practices and can be found in some similar form or variation in most types of professional practices. Attorneys know well what I am talking about. Many law firms make great use of the concept of "staff-partner leverage," where young employee attorneys are expected to carry normal workloads and to bill the same number of hours as shareholder attorneys, yet are paid far lower compensation. A young attorney pays his or her "dues" as an associate until ultimately being given the opportunity to buy-in to the firm and then realize shareholder level compensation. While some of this lower compensation for a young attorney arguably has to do with their lack of experience and not as a result of buying in (this will be discussed later in the context of Dr. Jones), I suspect that many attorneys would admit that their payment of dues in the form of lower compensation as an employee allowed the existing partners or shareholders to benefit.

Estimating the Total Implied Cost of the Buy-In. This section will examine the total implied price paid by Dr. Jones using some actual numbers to illustrate how this impact can be quantified.

The present value of Dr. Jones' hidden buy-in cost (in the form of foregone compensation) is not simply $375,000 in total (or $125,000 foregone in compensation per year times three years as an employee, or alternatively, $10,417 foregone on a monthly basis). Dr. Jones did not become a shareholder immediately on day one, but instead had to wait three years to begin receiving shareholder level compensation. Had he received the $10,417 more in compensation per month by becoming a shareholder immediately upon starting with the Practice (rather than waiting three years), he could have invested the additional monthly compensation (from the greater compensation he could have earned immediately as a shareholder) and earned additional money. Thus, the present value of the foregone compensation is less than the stated $375,000 in total over the three years.

In **Table 1,** the present value of Dr. Jones' foregone compensation is determined. That is, in today's dollars (as of the valuation date), assuming that Dr. Jones could have instead purchased the stock on the first day of his employment at the Practice and begun receiving the full shareholder compensation immediately (reinvesting the foregone earnings), what is the total present value of the earnings that were foregone by instead having to wait until the beginning of the fourth year? For this purpose, the monthly foregone compensation ($10,417) was discounted back to present value assuming Dr. Jones could have instead reinvested the money in 3-year U.S. Treasury notes, which had a yield, as of the date of Dr. Jones' buy-in, of 2.0% (actual three year rate on the valuation date in 2003). The calculations of the present value of the foregone earnings are determined in **Table 1** and are then added to the total "stated" buy-in price of $1,000 for the shares to arrive at the total implied buy-in price paid by Dr. Jones.

Therefore, Dr. Jones is inaccurate when he says the total buy-in price for his shares was $1,000. An attorney or business appraiser who simply looks at the $1,000 price paid in a stock register or shareholder agreement is missing the big picture. Obviously, the dynamics of the buy-in process will be different in

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Table 1
Total Approximate Value of Foregone Compensation in Dr. Jones' Buy-In to Orthopedic Surgery, P.A.

Annual Discount Rate	2.00%		
Equivalent Monthly Rate	0.1667%		

Monthly Payment Period	Foregone Compensation	Times: Present Value Factor	Equals: Present Value of Payment
1	$10,417	0.99834	$10,400
2	$10,417	0.99667	$10,382
3	$10,417	0.99502	$10,365
4	$10,417	0.99336	$10,348
5	$10,417	0.99171	$10,331
6	$10,417	0.99006	$10,313
7	$10,417	0.98841	$10,296
8	$10,417	0.98676	$10,279
9	$10,417	0.98512	$10,262
10	$10,417	0.98348	$10,245
11	$10,417	0.98185	$10,228
12	$10,417	0.98021	$10,211
13	$10,417	0.97858	$10,194
14	$10,417	0.97695	$10,177
15	$10,417	0.97533	$10,160
16	$10,417	0.97370	$10,143
17	$10,417	0.97208	$10,126
18	$10,417	0.97046	$10,109
19	$10,417	0.96885	$10,093
20	$10,417	0.96724	$10,076
21	$10,417	0.96563	$10,059
22	$10,417	0.96402	$10,042
23	$10,417	0.96242	$10,026
24	$10,417	0.96081	$10,009
25	$10,417	0.95921	$9,992
26	$10,417	0.95762	$9,976
27	$10,417	0.95602	$9,959
28	$10,417	0.95443	$9,942
29	$10,417	0.95285	$9,926
30	$10,417	0.95126	$9,909
31	$10,417	0.94968	$9,893
32	$10,417	0.94810	$9,876
33	$10,417	0.94652	$9,860
34	$10,417	0.94494	$9,843
35	$10,417	0.94337	$9,827
36	$10,417	0.94180	$9,811
Aggregate Total Present Value of Foregone Compensation			**$363,688**
Plus: Price Paid Per Share, Stated Buy-In Amount			$1,000
Equals: Total Implied Buy-In Price			**$364,688**

every practice, so this demands a fact specific view of the issue.

Implied Total Value Likely Overstates Reality of Buy-in Amount. The total implied price of $364,688 for Dr. Jones' buy-in is based almost totally ($363,688) on the value of his foregone earnings as an employee physician for the three years until he hopefully becomes a shareholder. All of this difference (in terms of compensation the entering Dr. Jones could have earned had he been a shareholder) was assumed a part of his buy-in amount. However, the reality is that this likely overstates the total implied value of the buy-in.

Dr. Jones was fresh out of training as are most purchasers of interests in medical or other professional practices. Even if he were purely an employee with no plan to make him a shareholder in three years, it makes sense that he would earn less than experienced physicians such as those shareholders already in the Practice. Therefore, some of what is being called compensation that is being foregone for a buy-in actually is lower compensation because Dr. Jones is simply less experienced. By contrast, the existing shareholder physicians have many years of experience. Even if those existing physicians were not shareholders, they would reasonably achieve a higher compensation level in the marketplace than an inexperienced physician like Dr. Jones. Dr. Jones is probably less efficient at seeing the most number of patients per day to generate the maximum revenues for the Practice and also does not yet have as many patients beating a path to the Practice to see him as do the experienced physicians. Thus, Dr. Jones may initially generate less revenue than his total cost to the Practice, leading the existing physicians to subsidize him. Therefore, it seems reasonable to conclude that an experienced physician or professional would be more desirable to an existing practice and might reasonably be able to negotiate and command a smaller amount of foregone compensation in a buy-in than an inexperienced professional.

As a result, these factors suggest that the value of foregone compensation includes some elements that are over and above a true buy-in amount. In reality, some of the foregone compensation that is being called a part of the buy-in amount really represents the fact that the entering physician is simply less experienced, and therefore should not make the same as experienced physicians, even if no buy-in were to have taken place. For these reasons, the implied value as previously calculated incorporates elements that go beyond the price paid for the shares and leads to an overstatement of the total implied share price. Therefore, the truth about the total value of the buy-in likely lies somewhere between Dr. Jones' claim of a $1,000 price and the higher total implied price previously estimated.

Total Implied Prices Paid in the Buy-Out Process. Dr. Jones also says that if he leaves the Practice he will only walk-away with $1,000 (the price he will receive for his shares under the buy-sell agreement), "proving" again that this is all his shares are worth. But is this true? A review of the specifics tells a different story.

At the time a shareholder physician leaves the Practice, he or she receives payment for his or her shares at an amount as set forth under the Practice's

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Buy/Sell Agreement ("Stock Agreement"). Dr. Jones, who has now (on the valuation date of 1/1/2003) been with the Practice six years, bought into share ownership three years ago on January 1, 2000 and is also subject to this Stock Agreement. In addition, each shareholder physician leaving the Practice also receives deferred compensation payments under terms set forth in the Practice Shareholder Physician Employment Agreement ("Employment Agreement"). Dr. Jones is subject to an Employment Agreement dated January 1, 2000 (signed the date he became a shareholder).

The Stock Agreement indicates that departing shareholders are to receive a price of $1,000 for their shares (it is also common to see medical practices and other types of professional practices use a similar nominal amount or yardstick, such as accounting book value). Therefore, the total stated value for Dr. Jones' shares in the event he wished to sell them or leave the Practice would be $1,000. However, as is discussed in the following section, a deferred compensation arrangement also is relevant in determining the total implied price, which is greater than the stated price.

Deferred Compensation. According to the Employment Agreement applicable to Dr. Jones (and the other shareholder physicians), in the event of retirement (the definition of "retirement" in the agreement states that it does not have to be retirement in the sense one normally thinks of, but can include leaving the Practice for any reason, perhaps to join another practice), death or disability, a shareholder physician is entitled to a payment of deferred compensation computed as follows:

> Fifty percent (50%) of the physician shareholder employee's average annual compensation (salary and bonus) received from Practice over the three (3) year period immediately preceding the occurrence of the event for which deferred compensation must be paid. Such deferred compensation shall be paid over a twenty-four month period, beginning on the first day of the month following the termination of employment."

Dr. Jones has now been a shareholder for three years (January 1, 2000 to January 1, 2003) and received shareholder compensation of $325,000 annually for each of those years, or an average of $325,000 per year. Under the above formula, upon terminating with the Practice, Dr. Jones would receive 50% (50% of $325,000, or $162,500) of his three year average compensation, or **$162,500**, paid in 24 equal monthly installments, without interest, of **$6,771** per month (rounded).

Therefore, since Dr. Jones is not paid deferred compensation immediately, but instead over 24 months, the present value of the proceeds is less than the stated amount due to the time value of money. Were Dr. Jones to receive the full payment of $162,500 at the time of departure, he could have invested the funds and earned additional interest. Instead, Dr. Jones has to receive the payments in installments, without interest, over 24 months. Therefore, in determining the estimated value of Dr. Jones' deferred compensation, per the Employment Agreement, the proceeds must be discounted to their present value on January 1, 2003, taking into account the time value of money.

Estimation of Deferred Compensation Due Dr. Jones Per Employment Agreement. Using the previously noted formula, it is now possible to estimate, per the Employment Agreement, the present value of the amount that was likely to be received by Dr. Jones for deferred compensation upon his departure from the Practice as of January 1, 2003.

The discount rate employed here is based on the prime-lending rate of 4.25% (as of the 1/1/2003 valuation date- this is a simplified example only and does not delve into other alternative ways of selecting the discount rate), plus 0.5%, the same as the Practice's borrowing rate per its bank line of credit. When a shareholder such as Dr. Jones takes the exit package, which is paid over 24 months, that shareholder becomes a creditor of the Practice just like the Practice's bank. Therefore, the rate of return associated with the 24 months over which it takes Dr. Jones (and other departing physicians) to receive his money should reasonably be comparable to the rate other similar creditors, such as the bank, must earn for the time value of money and risk of non-payment. Therefore, the discount rate used here is 4.75%, based on the same rate charged by the Practice's bank. Note that this discount rate is different than the one used in other valuation methods (not shown in this article) such as the income valuation approach for determin-

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ing the value of the shares. The capitalization rate used in an income valuation approach (such as the capitalization of earnings method) is based on a long-term rate of return for an equity holder in the Practice (and is based on a discount rate minus a long-term annual growth rate), subject to different risks and a variety of factors not present in an obligation paid equally over the period of only twenty-four months.

Since the deferred compensation is paid over 24 months, the calculations in **Table 2** convert the previously determined monthly payments into their present value at the valuation date, which, when added to the $1,000 stated amount Dr. Jones receives for shares the date he leaves the Practice, gives the grand total implied value for the transaction.

As is shown in **Table 2**, under the formula calculation Dr. Jones would be entitled to receive deferred compensation of $162,500 in total, paid in 24 monthly installments of 6,771 per month (rounded). When converted to present value, the total value of Dr. Jones' contractual deferred compensation payment is estimated at **$154,731**. When added to the $1,000 he receives for his shares at the time of departure, the total implied value is **$155,731**, not the $1,000 as maintained by Dr. Jones.

Table 2
Total Present Value of Payment of Deferred Compensation over 24 Months and Total Implied Value of Buy-Out

Annual Discount Rate	4.75%		
Equivalent Monthly Rate	0.3958%		

Monthly Payment Period	Deferred Compensation	Times: Present Value Factor	Equals: Present Value of Payment
1	$6,771	0.99606	$6,744
2	$6,771	0.99213	$6,718
3	$6,771	0.98822	$6,691
4	$6,771	0.98432	$6,665
5	$6,771	0.98044	$6,639
6	$6,771	0.97658	$6,612
7	$6,771	0.97273	$6,586
8	$6,771	0.96889	$6,560
9	$6,771	0.96507	$6,534
10	$6,771	0.96127	$6,509
11	$6,771	0.95748	$6,483
12	$6,771	0.95370	$6,458
13	$6,771	0.94994	$6,432
14	$6,771	0.94620	$6,407
15	$6,771	0.94247	$6,381
16	$6,771	0.93875	$6,356
17	$6,771	0.93505	$6,331
18	$6,771	0.93137	$6,306
19	$6,771	0.92769	$6,281
20	$6,771	0.92404	$6,257
21	$6,771	0.92039	$6,232
22	$6,771	0.91676	$6,207
23	$6,771	0.91315	$6,183
24	$6,771	0.90955	$6,159
Aggregate Total Present Value of Deferred Compensation			**$154,731**
Plus: Stated Price Paid for Shares, Date of Departure			$1,000
Equals: Total Implied Value of Buy-Out			**$155,731**

While the deferred compensation amount previously noted is not stated to be a payment for stock, it appears, in substance, to effectively be a part of the total consideration paid the departing shareholder physician, over and above the value of his or her shares under the previously noted formula (in this case, $1,000 for Dr. Jones's shares).

Why Part of the "Price" for the Shares Might be Paid in Deferred Compensation. As is often the case, tax motivated reasons are many times a driving force as to why professional practices choose to only pay a small stated amount for the shares (here, $1,000), with the remainder called deferred compensation, a retirement benefit, or some other similar name. By calling the bulk of the payment deferred compensation, a practice attempts to deduct the bulk of the amount paid the departing physician for practice income tax purposes, reducing the after-tax cost of the buy-out to the practice. For example, if the Practice is in a total 40% tax bracket (Federal and State combined), it can deduct the $162,500 in payments, saving the Practice $65,000 in taxes (40% of $162,500), lowering its true after-tax cost of buying Dr. Jones' shares to **$98,500**: $97,500 in terms of deferred compensation paid ($162,500 less tax savings of $65,000), plus $1,000 for the stock payment, which the Practice cannot deduct. This is much less than the $163,500 after-tax cost to the Practice had it actually paid the same full price in the form of payment for the stock the day Dr. Jones departed. Therefore, professional practices have a strong incentive to structure buy-outs in a similar fashion and to hide the true nature of a large part of the stock purchase price by calling it something else, like deferred compensation. Also, structuring the payment over time allows the Practice to spread the cash flow impact to the Practice of buying out the shareholder.

Attorneys Will Argue This is Not Part of the Stock Buy-Out Price. Once the attorneys for the divorcing professional get involved and filter the conversations with the professional or point to the agreements in cross-examination of the valuation expert in court, they will almost always maintain that to consider deferred compensation as part of the stock buyout price is nonsense. Instead, the attorney will say that the agreement does not refer to anything concerning the purchase of stock and clearly states that the payment is for deferred compensation, retirement com-

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pensation, or some other form of cash payment related to services provided, and therefore it is not a payment for the stock, but for something else.

However, our firm has experience in interviewing many physicians over the years, including in a large number of matters where litigation was not involved or in litigation matters where there was no filtering or coaching of what we were told. In virtually every circumstance when we ask about the deferred compensation or "retirement" arrangement, the physician and/or practice manager will admit either that it is structured this way for the tax reason mentioned, or that this is simply a way for the practice to pay the departing physician the value of their share of practice receivables that were left at the time they departed. Rarely, if ever, do they say these payments represent "deferred compensation" or "retirement compensation." Also, if it were retirement compensation, why does the physician also separately have benefits from money purchase pension and profit sharing plans in which he or she participated in the years he or she was with the practice?

Obviously, the facts may differ by circumstance, so the business appraiser and attorneys involved need to explore the full picture to determine how these issues are assessed and their relevance in the valuation process.

Buy-In and Buy-Out Values as a Reasonableness Test to Values by Other Methods. The values determined by consideration of buy-sell agreements and related contracts are not the only way to estimate the value of an interest in a professional practice. Other methods, such as the income (capitalization of earnings, discounted cash flow), market (sales of similar practices and practice interests) and cost (net asset value) approaches may be relevant for consideration and weighting, perhaps even to the exclusion of the total implied values as estimated under buy-sell agreements in certain circumstances. However, suppose the implied cost of Dr. Jones buy-in was $364,688 (which we have also shown actually really overstates the total value due to lack of experience and other factors). Similarly, the implied total cost of his buy-out is $155,731. Suppose the other expert in the case has used the capitalization of earnings and other methods and says the value of Dr. Jones' shares is $800,000.

If a physician like Dr. Jones can buy-in to the Practice for $364,688 (which we have already said is overstated) and be bought out for $155,731, this may suggest that the $800,000 value estimated by the other expert is completely unreasonable. If Dr. Jones' shares were truly worth $800,000, why would the shareholders of the Practice be willing to sell Dr. Jones his shares for at most $364,688? Similarly, why would Dr. Jones be willing to sell his shares back to the Practice for only $155,731 if they were "truly" worth $800,000?

If the Practice had no history of buy-ins or buy-outs, it may be that the formula amounts per buy-sell agreements and similar arrangements have never been used and might not be market evidence of prices paid. In fact, family law attorneys frequently make this point or argue that a formula price is simply a device in the buy-sell agreement to use at divorce time to argue for a lower value for one's shares and Ms. Jones' attorney might argue in Dr. Jones' case that the true value is $800,000. However, if there is a clear history of buy-ins and buy-outs and the totality of the impact of those transactions is also considered, the prices paid may, depending upon the facts, provide strong evidence to the contrary, i.e., that the $800,000 value estimated by other methods by the other business appraiser is overstated and ignores the true value of the much lower prices paid in real world transactions of the practice itself.

Buy-Out Price May be More Reliable in this Circumstance. We obviously have two different values based on buy-ins ($364,688) and buy-outs ($155,731). The obvious flaw of the buy-in value is that it realistically overstates the true implied buy-in cost, at least in Dr. Jones' circumstance, for reasons noted earlier. Part of what has been referred to as foregone compensation during the period as an employee is really related to the fact that Dr. Jones is simply less experienced initially and would, in the real world, earn less. This suggests that the value based on the buy-out, at least based on the facts in Dr. Jones' example, may be a more reliable indicator of the value of the shares.

Each Situation is Unique. The previous examples are highly simplified and could have considered a number of issues, such as possibly tax-affecting income streams (if indicated), the age of transactions, and numerous other factors that cannot be addressed in this limited space. Obviously, every situation is unique and must be judged on its own merits. There can reasonably be circumstances where the

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business appraiser puts no weight whatsoever on the kinds of total implied transaction values estimated earlier and relies instead on the findings of other valuation approaches, or, alternatively, places all or part of the weight on the implied buy-in and/or buy-out prices. However, the choice of which way to go must be reasonable and supported.

Impact of Case Law. Finally, relevant case law may have an impact on how buy-sell agreements are considered and the degree to which they are or are not conclusive of value in an equitable distribution setting. This will obviously differ in each state, so all of the foregoing must be considered in light of case law.

Conclusion. Things aren't always what they seem, and this is especially true in the prices paid for shares in the comings and goings from share ownership in a professional practice. Only by looking at the totality of the entry and exit process can the business appraiser truly see what is implied about the prices being paid. A close examination often results in a value that is much greater than the stated price.

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