CRITICAL PROVISIONS OF PRACTICE AGREEMENTS: GOVERNANCE, TERMINATION, BUY-OUT

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* Financial Interest

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Who We Are

• Business and legal advisors to physicians
• Publishers of the Goodwill Registry, used in valuation of ophthalmology and other medical practices
• Handle and advise re: practice buy-ins, buy-outs, sales, mergers and valuations

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The Value of Good Documents

- Compare
  - The short term costs of preparing good documents to
  - The long term costs of living without them
- Recipes for disaster
  - No documents
  - Doing your own documents
  - Verbal agreements not reduced to writing

What Do Contracts Do

- Establish the terms of the relationship (governance, compensation)
- Deal with future scenarios (buy-out, competition, termination)
- The process of creating the contract helps gets everyone on the same page

How Much Contract Do You Need?

- 5 pages or 50 pages
  - 50 pages may be “complete” but incomprehensible to the parties signing it (and cost a fortune to create)
  - 5 pages may not be enough
  - An attorney with good knowledge of your business/practice can help strike the right balance
Contracts Over Time

- The life of a contract varies
- Depends on changes in your key players (buy-ins, buy-outs)
- And changes in your business (changes in compensation formula or buy-out)
- Good base contracts can last for years, with amendments as needed
- Contracts should be (and generally will be) revisited as shareholders come and go

Contracts For Multiple Entities

- Each entity will need its own documents
  - Medical practice
  - ASC
  - Real estate entity
  - Lasik entity, optical entity
- Need to ensure proper coordination
- Example: If you are bought out of the medical practice, should you be permitted to continue as owner of other entities?

Medical Practice Documents

- Practice entities are typically PCs or LLCs
- PCs: Shareholders’ Agreement (buy-sell); Employment Agreements (for each shareholder); Bylaws; Articles of Incorporation
- LLCs: Operating Agreement; Articles of Organization
ASC Documents

- ASC entities are generally LLCs, but can be S corporations too
  - Need “pass-through” tax treatment
- LLCs: Operating Agreement; Articles of Organization
- S corporations: Shareholders’ Agreement (buy-sell); Bylaws; Articles of Incorporation; no Employment Agreements

Real Estate Documents

- Always put your real estate in a separate entity, not in the medical practice entity
- Do not use a corporation, for tax reasons
- LLCs: Operating Agreement; Articles of Organization
- Partnerships: Partnership Agreement, plus state filings (maybe), for limited partnerships

Optical Entity

- Should there be a separate entity?
  - Maybe, if there is a need to have optometrists as part owners
  - Or if doctors feel a different valuation model applies
  - But consider cost, complexity of extra entity
- Could be LLC or S corporation
Lasik Entity

• Should there be a separate entity?
  • Maybe, if not all physicians are willing to contribute needed capital
  • Could be LLC or S corporation

Other Entities

• Management company
• Equipment leasing company
• Employee leasing company
• Is there a true business purpose? True need? (again: cost, complexity)

Agreements Between Entities

• Medical practice will have lease with real estate entity, for use of space
• Medical practice may have management agreement with ASC (or Lasik or optical) entity, with cost allocation provisions
Coordination of Entities

• Generally each entity is owned by individual doctors
• Consider mirror image ownership, if possible
  • Dr. A owns 20% of medical practice, and 20% of real estate (or Lasik or optical) entity
  • Reduces or eliminates issues of inter-entity pricing (e.g. lease rate) and/or cost allocation decisions

Coordination of Entities

• Should a doctor who is bought out of the medical practice (e.g. because of retirement), continue as owner of other entities?
  • ASC
  • Real estate
  • Optical

Medical Practice

• Your core documents
  • Control the basic terms of your relationship with your “partners”
  • Have the most “moving parts” of any of your documents
Scope of Business Purpose

- What activities are within the purview of the documents?
  - Extent of permitted outside activities
  - Who keeps revenue from outside activities
  - Fiduciary duty of doctors – "corporate opportunity" doctrine
  - Scope of non-compete clause, post termination

Governance

- Who decides what?
  - Managing Physician versus Board
  - Board versus Shareholders
  - Founder versus other Shareholders

Types of Decisions

- Day to day administration
- Major purchase of equipment
- Incurring bank debt
- Signing leases
- Hiring and firing providers
- Office move/close
Types of Decisions

- Admission of new shareholders
- Termination of shareholders
- Merger or sale of practice
- Dissolution
- Changes to Bylaws

Required Votes

- Unilateral action by President/Managing Physician
- Majority Board decision
- Supermajority Board decision
- Shareholder decision
- Supermajority shareholder decision
- Founder veto? Tie breaker?
- Conflicts of interest/self-dealing: should interested shareholder be able to vote?

Required Votes

- Amendment of documents
  - Shareholders’ Agreement: Must all parties consent, for an amendment?
  - What about a lesser percentage?
  - Document must specify Employment Agreement changes require the employee’s consent
    - Consider provisions that give authority to Board: “Employee shall receive compensation as determined by the Board”
Compensation

- Permitted outside income?
- “Income Division Formula”: often “locked in”, for practices with 2-6 doctors
- Vs. Compensation Policy that can be changed by Board majority or supermajority vote
- May need changes over time

Termination

- Automatic: no vote needed
  - loss of license, commission of a felony, unable to obtain malpractice insurance
- Cause: vote needed (including vote of shareholder being terminated?)
  - exclusion from Medicare, sanction by professional society, loss of facility privileges, embezzlement, “material breach”

Termination

- Without cause (“at will”)
  - By employer vs. by employee
  - How much advance notice needed?
- What consequences for failure to provide the required notice?
  - Material breach – unspecified damages
  - Reduced buy-out
  - Other liquidated damages
Competition

- Should post termination competition be prohibited?
- Or just penalized, through reduction or elimination of buy-out?
- Any kind of right to injunction or out of pocket damages will be subject to local non-compete rules
  - E.g. Texas: must allow buy-out from non-compete at reasonable price

Buy-Out: Stock

- For corporation, payments to shareholder are after tax (no deduction)
- For recipient doctor, payments are capital gain
- Shareholder’s percentage ownership times overall corporation valuation

Buy-Out: Stock

- What is the corporation valuation?
- Typical formula for medical practice: modified net book value
  - Equipment values, plus inventory and working capital cash, less debt, retirement plan accruals
  - “Depreciation recalculated on a straight line basis over 10 years”
  - “No asset still in use valued at less than 20% of original cost”
Date and Method of Valuation

- Year ended prior to triggering event?
- Month ended prior to triggering event?
- Cash versus accrual accounting
- Accuracy vs. convenience

Stock Payment Terms

- Down payment plus installments
- With interest

Buy-Out: Deferred Compensation

- Deduction for corporation, ordinary income to doctor
- Could be accounts receivable (AR) plus “additional payment” (goodwill)
- Times percentage ownership
- Personal AR versus “corporate” (associate) AR
- AR valued based on actual collections, or on face value less payor disallowances
Another Deferred Compensation Formula

• Number of months of W-2 pay
  • E.g. “12 months’ Average W-2 Compensation”
  • “Average W-2 Compensation” equals average of salary and bonus payments to the shareholder over the 2 calendar years preceding termination
  • No separate valuation for AR or goodwill

Deferred Compensation Payment

• Generally paid over an extended period
  • E.g. 60 months
  • No interest

Limitations on Deferred Compensation

• To protect the practice (the goose that laid the golden egg)
  • Full value requires completion of buy-in plus some additional years of service (vesting)
  • No payment for goodwill if doctor competes
  • Penalty for lack of required advance notice
  • Total payments in any one year are capped
    • E.g. Not more than 3-5% of that year’s revenue
  • No payment if terminated for “cause”?
Clarity is Key

- How calculated and paid
- How limited

ASCs: Key Issues

- All profit shares and distributions are based on percentage ownership
- Buy-out valuation: Percentage ownership times entity valuation
  - Multiple of EBITDA (earnings)
  - "Fair market value as appraised"

ASCs: Key Issues

- Termination: when can a doctor be forced to sell?
  - Retirement from practice
  - Has sold shares in medical practice
  - No longer doing surgery
  - Does not meet "one third" test
  - Loss of license, felony, etc.
Real Estate, Optical

- Profit shares and distributions based on percentage ownership
  - No opportunity to pay individual doctors for services, except modest amount for management

Real Estate, Optical

- Advisable to require sale of equity when exiting medical practice
- Valuation
  - Real estate: fair market value per appraisal
  - Optical:
    - modified net book value, plus AR, plus (maybe) "additional amount" (goodwill)
    - Or a low multiple of earnings
    - No deferred compensation

Lasik Entity

- Probably handled like optical
  - profit shares based on ownership
  - valuation: modified net book value, plus AR, plus "additional amount" (goodwill)
  - Or a low multiple of earnings
- Could be handled like medical practice
  - Net income paid out based on work effort, via an Employment Agreement
  - Buy-out is modified net book value plus deferred compensation