Shareholder Agreements:
Identifying and Addressing Five Risk Areas

As most readers will be well aware, every group practice should have agreements providing the terms of employment of the physicians as well as terms related to the consideration the physician is to receive when he or she leaves the practice, whether by death, disability, retirement or otherwise. The organization's form of legal entity dictates the technical name of its particular agreements. A corporation will have a shareholders' agreement and each physician shareholder will have an employment agreement. A limited liability company (LLC) will have all such terms provided in its operating agreement. Likewise a partnership will have a partnership agreement. The issue of importance, however - regardless of the business structure and applicable title of the document - is that it is important that there be a periodic review of the provisions of the practice agreements so that there is greater assurance that the document is providing the protections and guidance that it was intended to. It helps the review process immensely to know in advance some of the areas that are most likely to require scrutiny.

This article discusses five specific items that have frequently proven to be problem areas of physician / shareholder documents either because they were not sufficiently well defined, or have simply not been addressed in the agreement. With an idea of what to look for, the administrator or consultant will be able to perform at least a preliminary review; perhaps heading-off a costly and more disruptive situation down stream

VALUATION FORMULA

One of the more important aspects of a practice agreement, the valuation formula provides the definition of which assets will be included and how those assets are to be valued in the event of a physician's termination of employment (and required disposition of their interest in the practice) whether by death, disability, retirement or any other termination.

Some agreements simply stipulate that a fair market valuation is to be determined by one or more appraisers. The author is generally opposed to this type of valuation clause for several reasons. First, the fair market value of a practice (unless otherwise defined by the document) will value intangible assets to include but not be limited to workforce in place, going concern, and goodwill. Under such a formulation it can become financially difficult for a practice to provide the required consideration to a terminating physician. In fact, the corresponding buyout amount may be so high that it becomes a race for the door, meaning the first doctor out wins. After the first valuation is completed this way the other doctors - seeing the resulting value and its consequences -, will frequently revert to a specific valuation methodology (as discussed below).

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Another weakness of using this type of overly-general valuation clause is that medical practice valuation experts will likely differ as to the value. As a result, a practice can spend a lot of time and fees with valuation experts in an attempt to come to agreement as to the fair market value. In sum, it is not recommended that the agreement state that fair market value by "appraisal" be the basis for valuation.

Rather, the author recommends that you have a more *specific formula* enumerating the *specific assets* that are to be included in the valuation and that the agreement provide a *specific methodology* on how those assets are to be valued. To wit; stating how the fixed assets are to be valued whether by net book value, some add-back of accumulated depreciation, or restatement of the fixed assets via depreciating them on a straight-line basis over a period of years with the resulting value to be no less than a certain percentage of the cost. The main point is that the agreement should provide the valuation formula so that the valuation calculation becomes a simpler more mechanical function; thereby avoiding significant fees, conflicts, and hard feelings over the myriad potential valuation issues.

Another consideration in regard to the valuation formula is whether it is consistent with the formula used for buy-in purposes. Generally, groups use the same formula for both.

Consideration should also be given to the tax ramifications of the amounts as well as the structure of the compensation to be paid by the practice to a terminating physician. For example, amounts paid for a physician's stock are nondeductible. The resulting tax rate can approximate 55% to 60% between the capital gain and state income taxes paid by the recipient as well as the corresponding tax paid by the "C" corporation (or owners of an "S" corporation) as a result of the nondeductible treasury stock payment. It is recommended that consideration for the accounts receivable be provided in the form of deferred compensation so as to provide a resulting income tax deduction and one level of tax (to the recipient of the deferred compensation).

MULTIPLE PAYOUTS

Without anticipatory clauses in the agreement a group practice can be financially crippled if it simultaneously has more than one terminating physician. Accordingly, the document should indicate that the amount paid by the practice for simultaneous buyouts will not exceed the highest amount paid to a single physician or will not exceed 125% of the first buyout. The intent is not to reduce the amount due a terminating physician but rather to allow for a more lengthy term on the payout. This provides a limit on the cash flow requirement each year to terminated physicians.

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PAYBACK PROVISION

The practice document should address payback provisions regarding two types of expenses. The first relates to the disallowance upon audit by the Internal Revenue Service or state revenue department as to any “individual direct expenses” of a physician. Basically these are expenses that have been paid by the practice on behalf of the physician and generally involve such things as meals/entertainment, conventions and meetings, etc. In the event that a doctor does not adequately document the expenses paid on his or her behalf and in the further event that these expenses are disallowed because of such documentation failure (or otherwise), the corresponding income tax, penalties and interest, if any, become an obligation of the business entity (if a C corporation) or to the other doctors (if an LLC, an S corporation, or partnership). The intent of the payback provision is to provide that the physician whose expenses are disallowed will reimburse the practice for the corresponding tax, penalties and interest. It is important that this provision be binding beyond the termination of the physician’s employment with the practice.

Similarly, many agreements provide a payback provision in the event costs are incurred as a result of a Medicare (or other payor) audit due to poor or inappropriate coding. The payback provision will require the physician whose coding caused the practice to reimburse the payor (and/or incurred costs to defend such “audit”) to reimburse the practice for such corresponding costs. This provision should also be binding beyond the termination date of the physician’s employment.

DISABILITY

One of the more difficult provisions of an employment agreement is to what extent and for what length of time a physician will continue to be paid in the event of an extended absence due to illness, injury, or a disability. The method of income division may well dictate the particular aspects for consideration.

As a general rule, many groups provide some remuneration: either full salary or a percentage to a physician during the first 90 days of his or her disability. However, a consideration quite often overlooked relates to practices that specifically allocate overhead to physicians. In this instance the question becomes how long and to what extent does the physician get allocated their applicable share of the overhead in the event of such an absence? Many groups provide that during the first 90 days of an absence due to illness, injury or disability the physician will be charged with his full share of the overhead. After 90 days they are not charged any overhead with the exception of any direct expenses paid on their behalf such as health insurance, etc. A corresponding question is: If the physician eventually returns to work after the extended illness to what extent are they charged with overhead upon their return? Keep in mind that after an extended illness the physician’s receivables may be pretty well

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collected and there may be very little, if any, revenue attributable to the physician's services prior to the extended absence. Accordingly, many groups provide that the doctor returning from an extended absence will be charged for the coming period only 50% of the overhead they would otherwise be charged, and for a length of time that they were out and had been charged the full allocation of overhead. For instance, a physician who returns to work after a 180 day absence will have been charged with a full overhead allocation during the first 90 days, no overhead for the next 90 days, and upon their return to work at 180 days they will be charged with 50% of their otherwise allocable share of overhead for the first 90 days after their return.

NOTICE PROVISION

Many agreements provide that if a physician elects to leave the group they must provide certain notice to the group. This notice requirement applies in the event of retirement or simply a voluntary termination and serves to provide the practice with adequate time to recruit another physician. Quite often a practice does not impute any penalty to a physician who fails to provide adequate notice. Without such corresponding penalty the notice provision it likely to have no real affect. If a group requires that a doctor provide 1 year's notice prior to retirement, for instance, what penalty, if any, will that doctor incur if he gives only 30 days notice? One method of addressing this is via a prorated penalty for each month that the doctor was to have provided notice but didn't. For instance, if a physician is to provide 180 days notice of his desire to voluntarily terminate his employment or retire but provides only 90 days, then he will receive only 50% of the amount otherwise due him under the practice agreements.

It is recommended that a group periodically review its documents to ensure that they are prepared consistent with the current desires of the group and that they have addressed the particular problem areas noted in this article.

Greg B. Gates, JD, CPA, is a Principal of Gates, Moore & Company, Atlanta, Georgia

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