

GUIDELINES FOR CORPORATE COVENANTS
AND
PHYSICIAN EMPLOYMENT AGREEMENTS

Steven Peltz, CHBC
Peltz Practice Management & Consulting Service, LLC
39 Old Doansburg Road
Brewster, NY 10509
voice 845-279-0226
fax 845-279-4705

ABSTRACT

Failure to set forth an appropriate framework for collaboration and employment between physicians can be the source of much distress and acrimony.

This article details some guidelines based on the author's consulting practice that will help physicians structure corporate or partnership agreements and terms of employment that are fair and clear.

Key Words: Medical corporations, medical partnerships; corporate structure; employment agreements; non-compete covenants.

***Editor's Note:** This article reviews concepts of structuring agreements that will serve as a basis for medical practice governing documents. It is presented as a guide to the reader's thinking and is not intended to be the basis for a legal document. It should facilitate your discussions with legal counsel to draft the appropriate agreement.*

You've heard these horror stories before.

Scenario 1. One physician of a three-physician practice died. There were no documents describing the process to follow when a partner dies, becomes disabled, withdraws or retires. The two remaining owners have a *new partner: their deceased partner's wife's attorney*. It is in the best interest of the deceased partner's wife that the attorney values the practice at a very high level. The remaining partners would like to pay something but definitely less than the attorney is suggesting.

Scenario 2. A partner has a heart attack. She tells the group her disability income program begins after 180 days, and as a result the group should pay her regular salary for 180 days. The group says her accounts receivable will support her salary for 90 days, so they will only pay her for 90 days. She then decides to sell her ownership back to the group and work part time as an employee. She says the value of the practice is worth X dollars and the partners say the practice is worth Y dollars. As a former partner she contends she should be paid 50% of collections. The group says it will pay only 40% of collections.

It's situations like these, that occur every week in real life that create confusion and chaos. These conflicts end up generating large legal and accounting bills and they corrupt your desire to "just practice medicine". This article will provide you with a guide to the step by step process on how to apply "preventative medicine" to the creation of one of your governance documents.

...you need governance documents..[to] plan for the future.

Your practice business entity can take the form of a corporation, partnership, or one of the limited liability entities. For the purposes of this article, I will describe the basics of a corporate shareholders' agreement (an owner owns shares of the corporation, hence the term shareholder), employment contract and deferred compensation agreement. Other entities (partnership, LLC...) may integrate these agreements. Whatever format of association you choose, guidelines are needed to govern the relations between physician partners.

Why do you need governance documents?

- Plan for the future: how to bring on new partners;
- How to pay and what amount to pay when a partner dies, becomes disabled, withdraws, terminated or retires;
- Management decisions – what type of vote – majority, unanimous, unanimous minus one is required for different decisions;
- How do we get paid and how do we divide up a bonus;
- What benefits should the business provide;
- How do we settle disputes; and finally,
- How do we break up?

SHAREHOLDERS' AGREEMENT

The controlling document of a corporation is the shareholders agreement.

On the first page it states the name and address of your practice along with the date the document becomes effective and the shareholders

Next come the various sections. They may not be in this order, and they may include but are not limited to these recitals.

TERM OF AGREEMENT - Delineate the circumstances that will prompt the corporation to dissolve. You may define these events if the entity declares bankruptcy or is not the survivor of a merger or other situations as your counsel suggests.

RESTRICTION UPON TRANSFER OF SHARES – Stipulate that shareholders cannot assign, sell or otherwise dispose of their shares to anyone but the corporation or another shareholder.

BOARD OF DIRECTORS – Usually each shareholder is a member of the Board of Directors

OFFICERS OF THE CORPORATION – Offices should rotate and be held longer than one year.

MANAGEMENT – What type of vote (unanimous, majority, unanimous minus 1...) is required for the following decisions:

- the employment of any new physician or provider by the Corporation,
- the offering of any stock of the Corporation to a physician,
- the hiring of a key non physician administrator of the Corporation,
- any change in the Shareholders Agreement, the compensation formula or the Deferred Compensation Agreement
- the sale of all or substantially all of the assets of the Corporation,
- any substantial change in the practice of the Corporation,
- acquisition of new bank loans or leases above a certain dollar limit, the termination of employment of any employee physician or Employee/Shareholder, .
- the adoption of annual capital and operating budgets,
- the firing of key non-physician administrators of the Corporation,
- any capital equipment expense in excess of a set dollar limit.

EMPLOYMENT- Shareholder will each have their own employment agreement with the corporation.

...a managing partner's... duties should be enumerated and any additional compensation should be noted.

SHAREHOLDER COMPENSATION – Each shareholder will be compensated based on his/her employment contract. If there is to be a managing partner who does more work for the corporation than the other shareholders, his /her duties should be enumerated and any additional compensation should be noted.

STOCK REPURCHASE – When the time comes to purchase a shareholder's shares, the valuation methodology and payment time frame used should be described. For example:

At the time shares are to be redeemed for death, disability, retirement or withdrawal (sometimes referred to as the "event", there could be two parts to the buy- out.

- *The first part* may be made up of the value of the non-depreciated assets (furniture, fixtures and equipment) from the end of the year before are to be totaled by the corporation's regular accountant. That number is to be divided by the number of partners. If that amount is less than \$5,000, the amount is to be paid within 30 days. If greater than \$5,000, the remainder or the residual amount is to be paid over the following six months. Depending on the amortization schedule previously utilized, this distribution may not be tax deductible to the corporation and treated as a capital gain by the receiving partner. (Remember this is just an example.)
- *The second part*, can be either the value of individual net accounts receivable to be paid over 12 months. An alternative suggestion is to calculate a negotiated percentage, possibly up to 75% of the average of the withdrawing partner's last three years' W-2 compensation.

That dollar amount is to be paid over 24-60 months. (To avoid financial stress to the partners and the corporation, limit the aggregate of all payments in any one-year for any reason to 4-6% of practice's net profit. The time frame can then be extended as needed This can be paid out as deferred compensation and is usually tax deductible to the corporation and treated as ordinary income by the receiving partner.

EQUIPMENT AND ACCOUNTS RECEIVABLE – The corporation owns all equipment and accounts receivable unless specified on an attached schedule.

DISSOLUTION, WITHDRAWAL AND RETIREMENT – To receive the maximum amount for shares, require one year's written notice in case of withdrawal or retirement. If less notice is given, the amount is reduced on a pro rata schedule. If you give up equal call (in an ob or surgery practice) it should trigger an automatic redemption of shares.

INDEMNIFICATION – If any of the shareholders or partners were in practice before the effective date of the agreement, they agree to indemnify their fellow shareholders against any action resulting from any incident that took place before they become shareholders of the new corporation.

ARBITRATION – Any dispute should first try to be solved through mediation. If that does not work some practices seek out the assistance of the American Arbitration Association.

MISCELLANEOUS PROVISIONS

1. *Governing law* – the document is to be governed by the laws of the state the practice resides in.
2. *Invalid Provisions* – if one provision is ruled invalid by a court, the remaining agreement will remain in effect as if the invalid provision were not part of the agreement. The invalid provisions may be replaced by a similar valid provision.
3. *Entire Agreement* – this is the entire agreement and nothing else orally agreed to will be counted unless it is added.
4. *Rules of Construction* – the singular includes the plural, the plural includes the singular, and any gender or pronoun includes the other gender.
5. *Force Majeure* – if anyone cannot fulfill an obligation due to forces of nature, labor unrest, a fire, flood or any such condition, they will not be liable for delay or failure to complete their obligations.
6. *Binding Effect* – the document is binding on all who sign it.

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YOUR EMPLOYMENT AGREEMENT

The first pages state that the corporation wants to hire you and you want to work for the corporation. Keep that in mind.

Again, these are some of the basic sections you may find in your employment agreement but not necessarily in this order.

TERM – the term of the agreement is for one year and is automatically renewed each year.

EXCLUSIVE SERVICE – you will devote your full time to the practice and will not engage in any other gainful occupation without the Board of Director's approval.

SCOPE OF DUTIES – A specific listing of what you will be doing:

- Treating patients
- Preparing charts
- Keeping records

- Keeping your skills and knowledge current through continuing medical education as stipulated by your state's Department of Professional Regulation (or other similar entity).

COMPENSATION – this depends upon too many variables (type of practice, number of physicians, revenue, overhead, formula used...) to go into detail here. However, do stipulate guidelines that offer flexibility and remuneration for certain practice exceptional activities.

FACILITY – you will be given space, supplies and staff commensurate with the type and style of your practice.

FRINGE BENEFITS – may include some or all of the following

- Malpractice Insurance including tail coverage should the policy require participation for a specified period before tail coverage becomes automatic (usually 5 or 10 years)
- Vacation and time off for CME
- Allowance for CME
- Health and dental insurance
- Group disability insurance
- Participation in a retirement plan
- Group term life insurance
- Auto allowance
- Communication allowance
- Allowance for dues and subscriptions

MALPRACTICE INSURANCE AND INDEMNIFICATION – You should have the same type (claims made or occurrence) and amount as all other physicians performing similar tasks. If you worked for another employer before joining this practice, you agree to indemnify the practice against any actions brought against it for all procedures performed by you before you joined.

RECORDS - All records are property of the practice. If you leave you can have a patient's records transferred only if the patient sends a written authorization. You will pay for the cost for copying. You can also have your accountant review the financial records of the corporation during normal business hours.

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VACATION/LEAVE OF ABSENCE – you are entitled to a number of weeks of vacation. If you are disabled, you will be paid for (remember this is for illustrative purposes only) 4 weeks out of any 12 months in addition to any vacation you have not taken.

DISABILITY - If you cannot perform the material and substantial duties of your occupation in the same manner and time (usually 80%) as is normally expected you are deemed disabled. If you can work part time your salary may be adjusted. If you are

permanently disabled for any 180 out of 365 days you may be terminated. During that time you will not be paid beyond what was previously agreed; any bonus you are entitled to will be paid on a pro rata basis; and you are prevented from voting your shares. If you come back to work within 180 days and are disabled again from either the same or a related injury or sickness within 24 months of the end of your previous disability, the days lost will be added to the previous days lost as if there had been no intervening time back at work. Being terminated as a shareholder does not prevent you from coming back and working part time as an employee..

TERMINATION – You **may** be terminated for the following actions – called *cause*:

If you lose your license to practice (maybe suspended?)

If you lose your DEA license

If you cannot obtain malpractice coverage

If you are suspended, barred or lose participation status in any federal, state or commercial insurance plan

If you commit a crime of moral turpitude or are convicted of a felony

If you lose your privileges at any of the practice's hospitals for more than missed meetings or incomplete charts

If you commit or are involved in substance abuse

If you exhibit behavior that may imperil the safety of patients or staff

If you are engaging in substance abuse

Other

NON-COMPETE COVENANTS—Because you were provided a cash flow and introduced to patients, staff, referring physicians, and were aided by the practice in obtaining hospital privileges, medical liability coverage, participation status with insurance companies, it would injure the practice if you were to leave and enter into a competitive activity with the practice. Therefore you agree not to do that with in a certain radius of any of the practice's facilities.

.It is best to agree on an indemnity amount at the outset if at all possible.

If you violate this you will pay the practice a specified indemnity. It is best to agree on an indemnity amount at the outset if at all possible. This avoids much wrangling and heartburn at separation. The indemnity might be set as a percentage of an average of the last three years' compensation.

Keep in mind, whether you are viewing the separation from the departing or the remaining partners' point of view, non-compete covenants that are too restrictive and/or fly against the local public interest will not be upheld or modified in court.

ARBITRATION – If possible try and use the American Arbitration Association or an impartial local group with which no one has a relationship. The American Health Lawyers Association (AHLA) is an excellent group but may be too expensive for a small practice.

ENTIRE AGREEMENT –Unless another document is affixed to this with both parties signature, this constitutes the entire agreement.

ASSIGNMENT – Neither party can assign this agreement without the other party's signature.

DEFERRED COMPENSATION

This document is designed to take the guesswork out of what you or your estate gets if you or any of your partners die, become disabled, withdraw or retire. The guiding principle is to first think about what you would like to get for your share of the ownership. Then think of it this way: are you comfortable giving your partner or his estate the same amount when they leave? If you are not, get your head out of the clouds.

You also need to decide how long you have to work at the practice before you qualify to receive any payment. Some practices keep it very simple. In those practices you or your estate receives one half of your net accounts receivable over the twelve months after you leave.

If however you like formulas and enjoy a more complex pay -out formula, here is one for illustrative purposes only.

QUALIFICATION

You have to work at the practice for ten (10) years before you qualify. You then accrue ten per cent (10%) of your buy out benefit a year. After twenty (20) years at the practice you are fully vested in whatever your benefit will be.

Benefit

As a guide, I look at one half (0.5) to one and a half (1.5) times the average of the last three years' W-2 compensation. The practice must have a replacement physician employed before the pay-out begins. The amount is paid as deferred compensation so it is fully taxable to the recipient and tax deductible to the practice. It is paid out over five years and it cannot exceed some percent of the practice's profit (say 4%) each year. If it does, the amount is capped and the time period is extended. In addition, you have to give one year's notice. For each month less than twelve, the benefit is proportionately reduced. The practice signs for it and the partners are not personally liable. Now how do you feel about simple versus complex?

Remember that the above discussion is a guide to the business issues of partnership/corporate governance and not a legal document, which can only be created by your attorney. Anything described herein is for illustrative and educational purposes only.

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