



Protecting Yourself in a Partnership

When establishing a partnership, your first inclination is to be trusting. Yet, everyone knows of someone whose co-ownership situation did not work out. However, it is a different matter when things do not work out and the procedures for separating are unclear or you find that you are not protected because your documents are insufficiently detailed. This article focuses on how to protect yourself in a partnership, particularly when admitting a new co-owner.

Trust — but Document

In all documents among co-owners, there are three main issues to address:

- Control and Governance
- Admission/Expulsion of Members
- Valuation: Compensation and Return on Investment

If you carefully address each of these three issues with your attorney when drafting documents (for each of your entities) you should be able to structure reasonable agreements that are fair to each party as well as flexible over time.

Control and Governance

There are two real issues with regard to control in every practice:

- How much stock do you allow the (new) co-owner?
- Who manages the practice?

How Much Stock Do You Allow the (New) Co-Owner?

Assume that you have made the decision to offer your associate co-ownership in your practice. How much of an equity interest do you sell him? Usually, your new associate will press you for an "equal" stake in the practice. In fairness, if you are to be equal on an ongoing forward basis, that makes sense. However, how do you then protect yourself, if you are really equal partners?

One common way to protect yourself is to sell less than an equal interest. For example, rather than sell your partner 50% interest in your practice, you might sell a 49% interest. This leaves you a 51% interest in the practice. In some situations, this might work. However, the first risk is your new partner's resentment and, at some point, your partner is going to insist on becoming equal to you in terms of stock ownership. The second risk is that, even with a majority interest, you might not be as protected as you think. Many states have laws that protect the minority shareholder so that the majority shareholder cannot act in a way that is materially adverse or against the interests of the minority shareholder.

Use a Stock Option

You could also consider selling your new associate an equal equity interest in the practice and taking back a "stock option." That option would give you the right to buy back the new partner's shares and prevent a liquidation from occurring if, for some reason, you ceased to get along. While these options are usually time limited, they often last for five to eight years, giving the senior doctor the flexibility to extend an offer of equal co-ownership to the new owner, while still knowing that he is protected in the

event the offer of co-ownership were unwisely made. The senior dentist retains the right to ask the new co-owner dentist to leave and to treat his shares as if they have been offered for sale back to the senior owner.

Protect Yourself in the Bylaws

As an alternative you might consider amending the bylaws of the corporation to state that, if there is ever a cessation of the business, the senior doctor has the right to continue to practice at the then-present office location, to use the practice's name, logo and other intangibles, to retain the practice telephone number, to retain the employment relationships with the current employees and technicians, to retain the patient charts and records, the practice books, and the like, for some designated time period.

Protect Yourself through an Effective Shareholders' Agreement

Of course, the new shareholder should also be obliged to sign onto the new shareholders' agreement. The shareholders' agreement obligates the shareholders to surrender their shares for repurchase if they ever cease to be a corporation employee for any reason, including death, retirement or other separation. It further obligates the corporation to repurchase those shares. The importance of the shareholders' agreement is not only that it limits *who* can be a shareholder with the other shareholders, but it also specifies the repurchase price, the formula for calculation, and the payment terms. In no event, should you leave something as important as the valuation of your corporation up to vague terms such as the "then to be determined fair market value." Your corporate value should be very clearly spelled out in your shareholders' agreement if you practice as a corporation; your operating agreement if you are organized as an LLC; and your partnership agreement, if you are organized as an LLP or the like.

It may also be important to you to identify who governs or manages the practice. If it is, then issues that go to the ongoing management, such as naming the managing partner, should be clearly specified in the documents themselves. While ideally you would be compensated for this position, and many managing partners are,¹ if you intend to be compensated, spell that out in advance.

Other Control Issues

In terms of the ongoing obligations to each other during the scope of employment, your agreements should clearly specify that each of the partners is to work exclusively for the practice so that no partner can establish a private practice on the side or keep any income outside of the practice. Most groups would also say that essentially all income from all sources—if it is related to the practice—is considered group practice income. Since most OMS practices divide income on the basis of productivity, considering that outside income as practice income credited to the productivity portion is not detrimental to the individual.

Likewise, it would be important that you include conflict-of-interest provisions in your agreements. For example, if one of your doctors has the opportunity to participate in an ambulatory surgery center, that dentist should be required to bring that opportunity to the other co-owners and not participate individually and alone (thereby keeping a separate income stream to himself that the other practice owners do not have the ability to share in). This should be an opportunity presented to the other corporate owners. If they elect to decline, then at least the decision was presented to them. Without the presentment, the doctor should not be permitted to participate in or take cases to the ASC.

In addition, most practices insist on maintaining restrictive covenants (except in the states in which they are not enforceable). The reason they do so is that these practices recognize that the longer a doctor has been with the practice, the *more* he has built up an established referral base, which is a valuable commodity for the practice. Recognizing that the doctor could leave and take that referral base—and, therefore, the income stream—with him to the detriment of the practice, many groups insist on keeping restrictive covenants in place even on senior partners. While not all groups agree with this

¹ The usual range of compensation for the managing partner is between 2% and 4% of the available "Net Income."

philosophy, in most cases where there is any kind of a significant financial buy-out, its value is usually reduced in the event of any subsequent post-competitive activity.

Admission/Expulsion of Members

It is important for you to consider *how* owners are admitted. Who can be admitted as an equity holder in the practice? Are there legal limits to who can own shares? For example, if you are licensed under the Board of Dentistry, then your co-owner must similarly be licensed under the same Board. This is what keeps businessmen from owing those shares in most states.

Likewise, how many votes are required to admit a new member? Is it a simple majority? How are members expelled? Can anybody be expelled, or are there some owners who can never be fired? Unlike the statutory, state law issues on who can be a co-owner, these are contractual/business decisions, that you may choose to implement to protect yourself in your ongoing employment. It is important that the core agreement resolve the issues as they pertain to the admission, retention, and expulsion of shareholders. It may also be important that, if an owner is fired as an employee of the practice, his shares are deemed to automatically have been offered for redemption to either the other shareholders or the corporation. This may be important for a number of reasons. First, you clearly do not want a fired partner to be in a position to vote. Second, you do not want that shareholder to be in a position to sell his shares to anybody else. Third, you want to be able to control the disposition of his shares so that he must sell them pro rata to the remaining shareholders or back to the corporation so that no one shareholder could own a disproportionately high number of shares relative to the other shareholders. Therefore, your shareholders' agreement needs to govern the disposition of shares in both favorable and less-than-amicable transactions.

Is ongoing employment for co-owners guaranteed? If the co-owner doctor commits an act that would otherwise constitute a "for cause" termination, is he *automatically* fired from the corporation, or is that employment termination discretionary as the board decides? If firing the co-owner is now within the board's discretion, can the co-owner who committed the egregious act vote not to terminate his employment?

These are important issues to consider, because most OMS practices are small. Usually, groups count on having a few rational surgeons to police the group, but removing even one of them may change the mix dramatically. Often decisions are made on an ad hoc basis and in a way that affects one particular doctor. For this reason, it is important to have these issues thought through in advance and to know whether you wish to use automatic provisions (which can be harsh) or to allow the board to use its discretion as implemented over time (which can result in uneven treatment, based on differing situations).

Valuation

Valuation is a tricky issue. There are two aspects to valuation. The first one is the value of the OMS practice, the ambulatory surgery center, the real estate and so on in terms of the buy-in and the buy-out that may be paid while the interests are held. Each of these entities is valued differently. The second aspect goes to compensation, which may be wages, including dividends, if you're talking about the practice, or it may be return on investment and dividends if you're talking about a surgery center or real estate.

Regarding the actual value of the entity involved, the date of the valuation should be clearly spelled out. Usually, you use the year ended immediately prior to or co-incident with the events that triggered the valuation. This is as opposed to a valuation "on-the-fly," which may not be ideal for many reasons, most of which having to do with accrued, but not reported, obligations.

It can also be very important to clarify the valuation method. For example, how is the entity to be valued? Is the valuation to be done on a cash or an accrual basis? Since the valuation method is likely to differ significantly by entity, this can be very important. For example, while most real estate ventures are valued on a comparable sales basis, most surgery centers are valued using a multiple of earnings, yet both of these transactions are usually structured as an after-tax purchase. Quite to the contrary, many buy-ins and pay-outs are valued based upon comparable sales analysis for goodwill, with a

blended pre-tax and post-tax structure. To protect yourself, you need the valuation terms, date of valuation and payment terms all clarified in advance in a document, so that it does not become a litigious issue if there is a question of value in an acrimonious split-up. This is where objective formulae work best.

It is also important to structure the payment terms. Usually, there is some down payment with the balance of the payment due over time. Are there any state or federal rules that would affect your plans?² The amount of detail goes to the amount of protection.

Regarding compensation and the expected return on investment, the first question to be asked is whether remuneration is compensation or a return on investment? How is it calculated and when is it paid? What are the differences and the tax treatment between the two? Are the distributions permissive or are they mandatory? Again, these distinctions are often very entity- dependent, but should be very clearly addressed in the documents so you are not held hostage by a partner who might, in an acrimonious situation, declare a dividend but not make it.

The compensation formula needs to be spelled out clearly in either a compensation plan or an employment agreement. The plan needs to be fair and needs to be simple and easy to implement. It needs to be clear whether compensation is calculated on a cash or accrual basis, who does the calculations and when, the level of oversight or accounting over the formula, and when the money is distributed.

It is also important to spell out how the entities are going to be valued. For example, while most associates buy into the practice within two to three years of first joining the Practice. That buy-in would be to not only the hard assets and equity values in the practice (for which the associate would purchase stock) but also to the goodwill and accounts receivable values in the practice. Obviously, the valuation principles and methodology should be clearly spelled out. However, purchasing, the initial half-interest is only the *first half* of the transaction. The whole arrangement should be spelled out in advance. What if something happens to you, the senior doctor, either before or during the transaction? The junior doctor, in agreeing to buy into the practice, is actually committing not only to purchase the *first half* of the practice now but also to honor any further buy-out obligations that the practice has to the senior doctor(s) in the practice. Therefore, the balance of the arrangements with the senior doctor(s) (regarding the buy out) need to be spelled out, as well.

Finally, all of these arrangements need to be fair to the parties involved. Therefore, regardless of how the practice is valued, that valuation should be fair and reasonable, and there should be limits on the practice requirement to make payment. For example, it is important that the practice valuation be clarified and known in advance. This is one of the reasons that it is so common for the practice valuation, in terms of accounts receivable and goodwill, to be tied to some measurement related to the previous year's income.³

Common protections for the practice, once the deferred compensation obligation is known and specified in the employment agreement, include the following:

- The deferred compensation will be reduced by the amount of sick pay received by the departing member within a 12-month period preceding the departure, unless the doctor returned to substantially full-time practice for at least 12 months
- The deferred compensation is an unfunded obligation and shall be expressly conditioned upon the departing doctor's non-competition with the practice. Therefore, the payment shall terminate and no longer be payable if, any time while receiving such payment, the departed doctor receiving such payment then enters into competitive practice, as defined in his or her employment agreement, whether or not entitled to compete.

² By way of example, the Medicare program frowns on loans between shareholders for the investment in ambulatory surgery centers.

³ Usually the equity values are tied to some formula based upon the adjusted net book value of the practice.

- The total amount of deferred compensation to be paid to one or more departed doctors shall not exceed 4% of the corporate gross receipts in any fiscal year. To the extent this limitation applies because one or more dentists or his estate is entitled to receive deferred compensation, the payment obligation to each shall be proportionately reduced to conform to the maximum payment obligation. Any reduced amount shall be added to the following entitlements to the doctor or his estate until paid in full.

- If a doctor leaves voluntarily (meaning not on account of his death or disability) on less than eight months' written notice to the Board of Directors, his deferred compensation shall be reduced by one-eighth for each month less than eight months' notice given.

- Deferred compensation shall also be reduced by the amount, if any, of expenses and benefits paid by the practice for the departed doctor that relates to periods after the date of the of employment termination. Such expenses and benefits may include, but not be limited to, dues, subscriptions and insurance premiums.

Additional issues that go to protections include the right to require the departed doctor be bought out of any and all additional or ancillary ventures in which he is a co-owner with the other dentists in the practice. For example, it would be very common for the owners and the practice to have established an ambulatory surgery center. To the extent that the doctors have done so, and the senior dentist retires from the practice, then he should be redeemed from his interest in the ASC. As with the dental practice, the issue of control in his required redemption should be clear, his management authority should cease, and the valuation of the ASC should be clearly specified.

In all entities, it is important that these three issues—control, management and valuation—be clearly specified at all times. Stay away from language such as, "fair market value;" it sounds good, but cannot be determined at any point in time, and different evaluators have different approaches. Be aware that "generally accepted accounting principles" means that you are going to keep your books on an accrual basis of accounting, which you probably do not want to do, at least for the dental practice. All of these little provisions are things from which your attorney needs to be able to protect you.

Finally, there are many issues to consider when you think about structuring arrangements between yourself and your partner(s). The important thing to remember is that you only need documents when things go poorly. While all good relationships are built on trust, it is the breakdown of trust that ends most relationships. Therefore, it is important that you trust, but document.

When you consider the time and energy you expend to structure the arrangements between you and your partner, you should consider each of the three elements above and ask if you have satisfied yourself that you are protected in each of these areas. The number one reason you went to your attorney in the first place was to be protected if the relationship did not work out.

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