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Shareholder Agreement Considerations

Many PMI clients often rely on a local attorney with limited experience on the nuances of a pediatric practice to draft a shareholder agreement. PMI provides this as a list of things to consider being incorporated into future versions of such agreements.

- The biggest challenge of a Shareholder Agreement is to recognize that the individual shareholder compensation needs to be broken into two distinct parts. The first part deals with the compensation for their time and energy providing medical care to their patients. The second part should reflect the financial rewards that come from owning a successful medical practice. When possible, care should be taken to distinguish these two facets.

- In addition to the usual boilerplate Shareholder Agreements for physician practices that can cover hundreds of issues, below is a list of items that are commonly overlooked. This is not to be considered legal advice- merely some observations based on my 20 years of experience in healthcare management.

    - **Personal Responsibility for Coding Audits**- To avoid improper coding/documentation penalties and recoupments from affecting the entire practice, consideration should be given to place language in the Shareholder Agreement that each provider is responsible for their coding/documentation. Should an audit determine that a recoupment is necessary, it should be the responsibility of that provider who made the error to pay the related penalties. Most shareholder agreements I've seen do not address this issue. More importantly, shareholder agreements do not address how potential recoupments are handled after the shareholder is bought out or leaves the practices. While I have seen attempts to hold employed providers to the same standard, it is often difficult to enforce due to labor laws. However, there are effective ways to recoup such amounts from employed providers who have received production bonuses in the past by way of what is referred to as a "clawback". Such provisions would need to be included in the employed provider's employment agreement.

    - **Spouse Approval**- To avoid any potential conflict after a shareholder dies or goes through a divorce, it is important that the Shareholders' spouses sign the shareholder agreement. If crafted properly, this eliminates any potential challenge(s) to the practice valuation and buyout process. While most states have default provisions related to how such situations are handled, this allows the practice to quickly squash any potential practice valuation challenges in the scenarios outlined above.

    - **Personal Guarantees for Financing**- Often times, the Shareholder Agreements have generic language about how personal guarantees for practice loans are handled. Care should be

taken to address whether or not such guarantees are on a pro-rata basis and whether or not the shareholders will indemnify each other's allocated guarantee. Whatever language you decide on need to be correlated to the final loan agreements- which will likely take precedence over the terms of your shareholder agreement.

- **Consecutive Days Out of the Office**- Due to the fact that the practice will retain a certain amount of overhead whether a shareholder is actively seeing patients or not, it can be a struggle for the practice to continue such costs if a shareholder is away for an extended period of time. Consideration should be given to decide how many days the shareholder can be away before an alternative compensation formula or forced buyout kicks in.

- **Disability**- The best Shareholder Agreements I've seen states that the shareholder's compensation will continue at the usual rate until their disability policy kicks in. This will necessitate that the shareholders carry a disability policy in some fashion that begins 45 – 60 days after the beginning of their disability. Having this provision will minimize the financial impact to the practice during a time when the practice may incur additional expenses to cover for the shareholder out on disability. For shareholders that are not able to obtain disability insurance, there are a variety of ways to escrow a portion of their salary each year for such contingencies or provide an alternative compensation formula for them.

- **Mediation / Arbitration Clauses**- It is advised that the practice include a provision stating if major decisions cannot be reach internally, that they request the assistance of an agreement upon neutral third party to facilitate a resolution. In the event that mediation does not resolve the matter, the Shareholder Agreement should state that the issue will be resolved by binding arbitration. It is important to have the binding arbitration included in the Shareholder Agreement in order to motivate the parties to come to a consensus in the mediation phase. Without such verbiage, the mediation phase will lack the authority needed to motivate a resolution on the disagreement.

- **Medical Malpractice Tail Coverage**- The Shareholder Agreement should address how the tail coverage for a departing physician will be paid for and whether or not this amount will be deducted from the buyout price.

- **Force Out Provision**- Assuming the Shareholder Agreement contains the explicit formula to value the practice, there should be a premium allocation (10 – 25%) to be paid in the event that the majority of the shareholders unexpectedly wish to buyout a particular shareholder. This provides a financial incentive to carefully select partners who are aligned with the shareholders before adding a new partner. More importantly, it provides some motivation for all the partners to weather the tough times.

- **Failure to Plan Provision**- Due to the time and expense incurred to recruit and groom another physician to one day become a shareholder, it is important that the practice have as much notice as possible of individual shareholder retirement plans. The Shareholder Agreement should contain a provision that if a physician does not provide at least 2 or 3 years notice of their intention to retire, the buyout amount is discounted by 25%. Obvious exceptions would apply for disability. This would also apply to the standard provision that in order to be a shareholder, he/she must be eligible for Medical Malpractice coverage.

- **Pledging of Assets**- The Shareholder Agreement should specifically state that the individual shareholders cannot collateralize their stock ownership in any fashion. Specifically, they cannot pledge their stock in the practice as guarantee for any personal loans, etc.
- **Personal Bankruptcy**- The practice should seek legal counsel concerning how to minimize the impact resulting from an individual shareholder filing for personal bankruptcy. The last thing the practice needs is a third party meddling in the practice.
- **Update Practice Value Annually**- With a predetermined formula, the process to update the practice value each year should be quick and easy. The shareholders should take the time each May to collectively update the valuation formula and make discuss any necessary adjustments. After the shareholders update the practice value, the individual shareholders should sign off on the updated value. In the event that the shareholders cannot agree on a new value (or forget to do this), the last agreed upon valuation will serve as the amount for any buy outs until the following May. This is particularly helpful in the event on the untimely death or divorce of a shareholder and eliminates a variety of problems. The month of May is ideal since the previous year's tax return should have been filed in April and the shareholders can meet before they start taking summer vacations.
- **Future Expansion / Financing**- In the event that a practice looks to acquire another practice or incur any significant debt within a few years of a buyout, it is important to recognize such an investment. Care needs to be taken to avoid a scenario where a shareholder reduced their earnings in a given year to fund the acquisition yet is bought out before the investment is recouped. More importantly, how does the Shareholder Agreement handle the following scenario: Two physicians invest $100k in a new location. Instead of taking a loan, they reduce their income for the year by $50k each. One of them dies during the next year and the practice value is highly influenced by the balance sheet. How do you compensate the heirs for the reduced income in the previous year and loss of benefit from that investment? While every situation is different, one way to mitigate this problem is to obtain outside financing to fund such efforts. While this does not mitigate all the issues, it does address one part of the equation.