David J. Shuffler

Presents

THE PARTNERSHIP TRACK

Here's How to Create a Successful Associate Ship and Meet the Challenge of Partnership Creatively and Productively

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INTRODUCTION

Medicine in the new millennium is big business and as economic and clinical pressures increase, solo practitioners and small doctor partnerships will become more and more vulnerable. Since these practices do not have successor management, the doctor owners are at risk financially and the continuity of the practice is threatened.

The financial capacity and doctor manpower required to provide expanded hours, invest in clinical technology, install sophisticated computer systems and develop internal and external marketing strategies may be beyond the reach of most solo practitioners and small group practices.

Associate practice is a winning strategic response to the market forces that are changing the way doctors practice medicine. Associate practice provides the associate doctor with a career path and the owner doctor with a viable exit strategy. Associate practice assures patients they will continue to receive quality medical care.

In order to create a successful associate ship and, then, turn it into a successful partnership, the associate doctor and the practice owner must be compatible. They must share the same personal and professional goals and objectives. The owner doctor and the associate doctor and prospective partner must be on the same page.

Each doctor must understand the responsibilities of associate ship as well as the duties and obligations of partnership.

The associate doctor must have a strong work ethic, good clinical skills, executive capability and entrepreneurship. The owner doctor must be more critical in promoting his or her associate to partner; more pragmatic in designing a partner doctor compensation model; and more sensitive to pay out arrangements.

WHEN IS IT TIME TO HIRE AN ASSOCIATE DOCTOR

The number one reason an owner physician should hire an associate doctor is clinical overload. If a practice is threatened by clinical overload, it is time to hire an associate.

Here is a test that will enable you to determine whether it is time for your practice to hire an associate doctor:

		YES	NO
1.	Does the practice suffer from appointment backlog?	____	____
2.	Is the waiting room too small because you are behind schedule?	____	____
3.	Is the staff harassed and irritable?	____	____
4.	Does the staff make mistakes because they are distracted?	____	____
5.	Are patient complaints on the rise?	____	____
6.	Is the time you allocate to each appointment getting shorter?	____	____
7.	Are referents annoyed because patients can not get a timely appointment?	____	____
8.	Is production stagnant?	____	____
9.	Is the practice overhead expense ratio on the rise?	____	____
10.	Is practice income lackluster?	____	____

If you answered YES to at least seven of these questions, it probably is time to hire an associate doctor.

CAN THE PRACTICE AFFORD TO HIRE AN ASSOCIATE

In order to determine if you can afford to hire an associate doctor, you have to calculate the incremental amount of production and total income collected you must generate in order to meet the expense of hiring an associate doctor and break even.

$$\textbf{BREAK-EVEN POINT} = \frac{\textbf{TOTAL FIXED COST}}{\textbf{1.0 - \% VARIABLE COST}}$$

DEFINITIONS:

Total Fixed Cost. Any expense a practice incurs that does not vary with the number of patient visits. Fixed expenses include staff wages, payroll tax and fringe benefits such as professional liability insurance, health insurance and professional dues as well as occupancy expense such as rent, HVAC and common area charges.

Variable Cost. Any expense a practice incurs, such as clinical supplies and laboratory and X-ray fees that varies with patient service. % Variable Cost is the ratio of variable expense to either gross billings or collections.

Doctor Doktor Family Medical Center is a solo family practice owned by Marc Doktor, M.D. For the twelve months ended December 31, 200X, the practice generated production of $650,940. Total income collected was $495,715.

Doctor Doktor recruited an associate doctor who will start work June 30, 200X. The cost of recruiting and hiring Doctor New is as follows:

Professional Compensation	$ 115,000
Professional Liability and Health Insurance	15,000
Professional Dues	1,000
Continuing Education	2,500
Payroll Expense	11,500
Total Fixed Cost	$145,000

In addition to these expenses, Doctor Doktor also incurred recruitment costs of $2,500 and plans to spend $3,000 to introduce Doctor New to his patients and referral sources.

Doctor Doktor Family Medical Center % variable cost is 14.5% of total income collected.

Here's how to determine if Doctor Doktor can afford to hire Doctor New:

Step One:

Calculate the amount of total income collected that the practice must generate to meet the expense of hiring Doctor New and break even.

$$\text{BREAK-EVEN POINT} = \frac{\text{TOTAL FIXED COST}}{\text{1.0 - \% VARIABLE COST}}$$

$$\text{BEP} = \frac{\$150{,}500}{1.0 - .145}$$

$$\text{BEP} = \$176{,}025$$

Step Two:

Calculate the amount of gross billings the doctor must generate in order to meet the expense of hiring Doctor New.

$$\text{BREAK-EVEN POINT} = \frac{\text{COLLECTIONS TO BREAK EVEN}}{\text{UNADJUSTED COLLECTION RATIO}}$$

$$\text{BEP} = \frac{\$176{,}025}{.762}$$

$$\text{BEP} = \$231{,}004$$

If Doctor Doktor Family Medical Center possesses the requisite internal and external dynamics to generate incremental production of $231,004 and incremental collections of $176,025, Doctor Doktor can afford to hire Doctor New.

WORKER STATUS: EMPLOYEE OR INDEPENDENT CONTRACTOR

The issue of worker status is statutory. Revenue Ruling 87-41, 1987-1 CB 296, sets forth twenty common law factors that determine whether a worker is an independent contractor or an employee.

Control is the most important factor. If a worker is subject to the will of the employer, said worker is an employee, not an independent contractor. Intent to control is key.

For example, if the employer doctor establishes set hours for the associate doctor, the employer is demonstrating control. Control is also implied if the associate is required to work full time and if the work is done at the office of the employer.

The following table summarizes some of the factors outlined in the revenue ruling that determine worker status:

Instructions

An associate who complies with instructions regarding administrative and clinical protocol is an employee.

Supervision

An independent contractor hires, pays and supervises his own assistants.

Work Schedule

Control is implied if the employer doctor sets the work schedule of the associate. Independent contractors establish their own hours.

Full-time Employment

If the associate is a full-time employee of the practice, the employer is demonstrating control.

Tools and Materials

If the employer furnishes the associate with tools and clinical supplies, control is implied.

Discharge

The right of the employer doctor to fire the associate indicates the associate is an employee not an independent contractor.

Restrictive Covenant

An independent contractor has the right to make his or her services available to the general public. If the associate executes an employment agreement that contains a covenant which restricts that right, the associate is not independent. He is an employee.

Worker status is a hot topic for both the Internal Revenue Service and workers. The IRS views a worker status audit as an opportunity to capture lost payroll taxes; an employee views it as a chance to obtain lost benefits such as pension and/or profit-sharing contributions.

The market forces that argue for classifying a worker as an employee outweigh the forces that argue for independent contractor status. Be smart. Get help. Avoid trouble.

If you want to classify your associate as an independent contractor, request a ruling from the IRS before you hire the associate doctor.

ASSOCIATE DOCTOR COMPENSATION

Should an employer doctor pay an associate doctor an annual salary with an incentive bonus and a fringe benefit package or should the associate receive a percentage of his collected revenue.

The advantages of salary based compensation are:

1. It provides security as well as an incentive for the employer and the associate.
2. It controls practice overhead expense.
3. It eliminates the potential for over utilization of diagnostic services.

The incentive bonus could be as much as 50% of the annual salary of the associate doctor. Eligibility is determined according to performance criteria established by the employer doctor and agreed to by the associate. The actual bonus should be paid each quarter based upon an employee performance review.

Fringe benefits, which include professional liability insurance, health insurance, continuing education allowance and professional association dues, complement the annual salary. Personnel policy will dictate vacation time and the number of paid sick days as well as pension or profit sharing eligibility.

The advantages of percentage based compensation are:

1. It provides an incentive that could stimulate production.
2. It enables the associate doctor to participate in the growth of the practice.
3. It converts associate salary to a variable expense which enables the employer to control fixed practice overhead.

The disadvantages of percentage based compensation are:

1. It might create competition for patients.
2. It may foster unethical behavior.
3. It could create financial insecurity for the associate doctor.
4. It may reduce the income potential of the employer doctor.

THE NEW DOCTOR EMPLOYMENT AGREEMENT

The associate doctor employment agreement does not have to be a document replete with legalese. It can be a legally binding non adversarial letter.

Writing an employment agreement is a challenge. First, define your goals and objectives regarding associate practice. Do you want to hire a practice builder or a patient manager? Do you want to develop a clinical team? Are you interested in providing your associate with a long-term career path or are you interested in improving the quality of your lifestyle?

The question of worker status is difficult to answer. When in doubt, be conservative. Opt for employee classification.

If the associate doctor is a candidate for co-ownership, the agreement should say so. The contract should specify the details of the buy in option such as the date of the purchase, the percentage of the practice the associate is eligible to buy and the purchase price and method of valuation.

Make sure the employment agreement says exactly what you want it to say. If it does, you will avoid misunderstandings and ensure a successful relationship.

Here are some guidelines that will help you write the right agreement:

1. Term of Employment. The term of employment refers to the period of associateship.

2. Scope of Duties. It is essential that the employer provide the associate with a detailed job description.

3. Ownership. Employment does not entitle the associate to a financial interest in the practice. The employment agreement should specify that the associate will not be required to contribute capital toward the operation of the practice nor will he receive any financial interest in the assets of the practice.

4. Restrictive Covenant. A restrictive covenant is a contract provision that prohibits the associate doctor from practicing in a specific geographic area for a specified period of time. If the covenant meets the five tests of reasonableness, a restrictive covenant is legally enforceable in most states.

5. Non-solicitation agreement. A non-solicitation agreement prohibits a former employee from soliciting the patients, staff or referents of the practice. A non-solicitation agreement may be more important than a restrictive covenant.

6. Acceleration. An acceleration clause gives the employer the right to accelerate the purchase option clause of the contract.

PARTNERSHIP: PRACTICE VALUATION

Step one on the path from associate doctor to partner is to conduct a practice appraisal and determine the value of Doctor Doktor Family Medical Center.

Establishing the value of a medical practice is complicated, but not difficult. Rules of thumb are dumb and do not work, and since few, if any, professional practices are comparable, the market approach has severe limitations.

The cost approach disregards professional goodwill and, since the discounted-future-return method relies on a projection of future earnings, it can be misleading. The excess-earnings method is difficult to apply and has a history marked by controversy and misuse.

In the opinion of the presenter, the debt capacity method of appraisal, which focuses on the amount of professional goodwill that can be transferred from one doctor to another, is the most fitting approach to use to value a medical practice

Here's how to use the debt capacity method to value the Doctor Doktor Family Medical Center.

	FYE 12/31/0X	Add Backs	Adjusted Statement
Total Income Collected	$495,715		$495,715
Medical Supplies, Lab and X-Ray Fees	31,230		31,230
General & Administrative Expenses	283,053	($65,830)	217,223
Depreciation	15,268		15,268
Total Practice Expenses	329,551		263,721
Gross Practice Income	166,164		231,994
Professional Compensation	165,000	($25,000)	140,000
Net Practice Income	1,164		91,994
Add: Depreciation	15,268		15,268
Cash Flow for Loan Amortization	16,432		107,262
Less: Loan Amortization: Interest	8,487	($8,487)	0
Adjusted Net Cash Flow	7,945		107,262
EBITDA	$16,432		$107,262

Step One.

Eliminate non-recurring expense items and perquisites and normalize the income statement. In other words, add back extra-ordinary and unusual expenses and determine the true cash flow of the practice.

For example, portions of the expense centers Rent, Insurance and Professional Fees are extra-ordinary or perquisites. Expense centers such as Automobile and Travel & Entertainment are perquisites and a portion of the expense center Repairs and Maintenance is non-recurring.

Step Two.

Calculate a market rate of professional compensation. An alysis of market conditions indicate that Doctor Doktor Family Medical Center professional compensation should be 33% of collections.

Step Three.

Since the buyer assumes all assets are owned free and clear of liens, eliminate interest charges.

Step Four.

Use the following equation to calculate the value of Doctor Doktor Family Medical Center:

DEBT CAPACITY VALUATION MODEL

$$\textbf{VALUE} = \frac{\textbf{ADJUSTED NET CASH FLOW} \times \textbf{AMORTIZATION FACTOR}}{\textbf{DSCR}}$$

ASSUMPTIONS:

1.	Adjusted Net Cash Flow	$107,262
2.	Debt Service Coverage Ratio (DSCR)	1.84
3.	Amortization Factor	4.921
4.	Capitalization Rate	37%

The appraised value of the tangible assets and patient records of Doctor Doktor Family Medical Center, P.A. is $287,500.

INCOME DIVISION: DESIGNING A DOCTOR PARTNER COMPENSATION MODEL

Since more practices break up because of income disputes than any other reason, the key to a successful partnership is the doctor compensation model. If income division is not equitable, it will break up the partnership.

For example, if the goal of the doctor partners is practice expansion, the model might emphasize productivity. Conversely, if the goal is team building, equal distribution may be more appropriate.

The obvious advantage of equal distribution is simplicity. On the other hand, equal distribution does not compensate the managing partner for his management skill nor does it spark production. Productivity distribution may be divisive and foster unethical clinical behavior or competition, which is not in the best interest of the practice or the patients.

Instead of a traditional compensation model, why not combine an annual salary with an incentive bonus that is based upon productivity. Compensate each doctor partner for his investment in the practice and pay the managing partner for his management skills.

Here's how to create a compensation model that is fair to everyone:

DOCTOR DOKTOR FAMILY MEDICAL CENTER PARTNER COMPENSATION MODEL ASSUMPTIONS

Fair Market Value as of December 31, 200X	$287,500
Doctor Doktor Shareholder Interest	55.0%
Doctor New Shareholder Interest	45.0%
Fiscal 200X Annual Doctor Wages	140,000
EBITDA as of 12/31/0Z	107,262
Management Fee	25,000
Profit Distribution	82,262
Return on Shareholder Investment	28.6%
Fiscal 2008 Annual Doctor Wages	255,000
Estimated EBITDA of 12/31/0Z	107,262
Management Fee	25,000
Profit Distribution	$82,262
Return on Shareholder Investment	28.6%
Estimated 200Z Incentive Bonus	NA
Actual Physician Productivity as of 12/31/0X	
Doctor Doktor	100.0%
Doctor New	NA
Estimated Physician Productivity as of 12/31/0Z	
Doctor Doktor	76.0%
Doctor New	24.0%

If the partners assume a return on shareholder investment of 28.6%, the aggregate shareholder profit distribution is approximately $82,262. Since Doctor Doktor owns 55% of the practice, he will receive $45,244. Doctor New, who owns 45%, will receive a distribution of $37,018.

Doctor Doktor will manage the practice and receive a management fee equal to 3.5% of total income collected or $25,000.

Now the practice must compensate each dentist for rendering professional services.

If the annual doctor salary of Doctor Doktor is 33% of fiscal 200X collections and, if Doctor New earns $115,00 in accordance with his employment agreement, aggregate doctor salary will be $255,000 in fiscal 2004.

Incentive bonus compensation is equal to the incremental increase in EBITDA. Since Doctor Doktor is working at maximum clinical capacity and collections of Doctor New are at break even, the incremental increase in EBITDA is nil. Fiscal 2004 incentive bonus compensation is zero.

Since Doctor New probably can not afford to pay for his entire partnership interest at closing, he could limit his cash purchase to the amount of the tangible assets and arrange an installment sale to pay for the patient records.

For example, if we assume the value of the equipment is $87,500 and the value of the patient records is $200,000, Doctor New would pay Doctor Doktor $39,375 for the tangible assets at closing and arrange to pay for the patient records over a five year period. A compensation differential of $18,000 will amortize the purchase of said records.

Compensation differential is a tax strategy. Doctor New will receive significant tax savings if he can shift income and pay for his partnership interest with pre-tax dollars.

However, since Doctor Doktor will now pay ordinary income tax on the gain over basis, the compensation differential should take in to account the tax differential between ordinary income that would accrue to Doctor Doktor on a installment sale and capital gain income which would accrue on a cash sale.

Doctor Doktor is also entitled to charge interest on the installment purchase.

Since tax code provisions are complex and ever-changing, questions regarding compensation differential should be reviewed carefully with accounting professionals.

DOCTOR DOKTOR FAMILY MEDICAL CENTER PARTNER
FISCAL 200Z COMPENSATION MODEL ASSUMPTIONS

DOCTOR DOKTOR		DOCTOR NEW
$140,000	Annual Salary	$115,000
25,000	Management Fee	NA
165,000	Guaranteed Payments	115,000
45,244	Profit Distribution	37,018
210,244	Sub-Total	152,018
NA	Incentive Bonus	NA
210,244	Sub-Total	152,018
18,000	Compensation Differential	(18,000)
$228,244	Total	$124,018

ASSIGNMENT:

Please answer the following questions.

1. Was the timing of Doctor Doktor's decision to hire Doctor New premature?

2. Could Doctor Doktor afford to promote Doctor New to partner?

3. Was the decision to promote Doctor New to partner a good business decision? Was it a good personal decision? Was it a good professional decision?