

## LITIGATION SUPPORT

### RESTRICTIVE COVENANTS. HOW ENFORCEABLE IS YOUR CONTRACT?

**Q.** Recently, I met a doctor who practices in my home town. The doctor wants to sell his practice and I want to buy it. We negotiated the terms of sale and my attorney is preparing the purchase and sale contract.

I want to make sure the seller doesn't practice in the primary catchment area. Will a restrictive covenant restrain him from competing with me?

**A.** A restrictive covenant is a provision in an employment agreement or a purchase and sale contract that prohibits a doctor from practicing in a defined area after he leaves the employ of a practice. Covenants are enforceable if they meet five tests of reasonableness:

1. Is the covenant in the public interest?
2. Is the covenant necessary to protect the economic interest of the practice?
3. Is the covenant fair to the restricted employee?
4. Is the covenant reasonable in duration?
5. Is the covenant reasonable in distance?

Despite the test of reasonableness, a number of states neither honor nor enforce restrictive covenants. Some states prohibit all covenants; others prohibit employment covenants but permit covenants in the sale of an ownership interest in a practice.

Violating a restrictive covenant is risky. Unless a restrictive covenant is specifically prohibited in your state, I would include it in your purchase and sale contract.

### WHAT IS THE PRICE OF SOLICITATION.

**Q.** In mid-2006, I hired an associate doctor. Although we got along well, we terminated our relationship prior to the expiration of her contract and she started her own practice.

Since her practice is located outside the area restricted by the agreement, she didn't violate the restriction. However, she did solicit patients of the practice and violated the non-solicitation agreement.

Can I recover the value of the patients who left the practice?

**A.** Patient records are a valuable and unique asset of a medical practice. If your former colleague solicited patients and they stopped coming to your practice, you were deprived of the economic rights provided by these lost patient visits.

You may be entitled to damages. Speak with your attorney.

## WHO RECEIVES CUSTODY OF THE OFFICE WHEN THE "MARRIAGE" FAILS?

**Q.** My associate has excellent clinical skills and she is a good patient manager and strong practice builder. We are compatible and enjoy working together. She will make a great partner and I want to sell her part of my practice.

If we have a disagreement after we become partners, how do we resolve our dispute? If our disagreement is irreconcilable, then what do we do?

**A.** In order to resolve any dispute, you must compromise. If your difference is irreconcilable, you, the senior partner, could invoke a senior-doctor option.

This option gives you the right to re-purchase the partnership interest of the junior partner and retain the office lease, telephone number and patient records.

## **STRATEGIC PLANNING**

### THE STANDARD OF VALUE WILL SHAPE THE VALUATION CONCLUSION.

**Q.** I am the founder and senior partner of a two-doctor internal medical practice which I started in 1983. In 1989, Dr. EB became an associate; in 1992 he became a partner. I own 60% of the practice; Dr. EB owns 40%.

The buy-sell provision of our shareholder agreement sets forth the method of appraisal, but it doesn't address the standard of value. Since we are revising the agreement, our attorney said we should define the standard of value because it could have an impact on the value of the practice.

What does he mean?

**A.** There are two definitions of value. Fair market value is the price at which a practice would change hands between a willing buyer and a willing seller.

Fair market value assumes a doctor-owner will sell his ownership interest and discontinue practice. Since there will be a change in doctors, it is likely there will be erosion in the amount of services rendered and the value of the patient records.

Fair value assumes a doctor-owner will retain his ownership interest in the practice and continue to practice. Since there will be no change in doctors, patient service will continue without interruption. It is not likely patient service will erode nor will the value of the patient records diminish.

Depending on the standard of value, an appraisal could produce vastly different valuation conclusions. Fair value might be 20% to 25% higher than fair market value.

If the purpose of the valuation is to buy or sell a practice, you should use fair market value. If the purpose is merger, revising your shareholder agreement or engaging in estate planning, use fair value. If the purpose is litigation, consult your attorney regarding the appropriate standard of value.

#### DOES A BUY-SELL AGREEMENT RESTRICT MARKET VALUE.

**Q.** I am the founder and senior partner of a three doctor urology practice that generates collections of \$1,825,000. I own 45% of the practice; Dr. FT owns 35%; Dr. NS 20%.

Our buy-sell agreement states that the value of the practice is equal to the book value of the equipment and furniture plus the value of the accounts receivable and patient records. We agreed that the value of the records would be equal to 25% of collections.

I want to sell my ownership shares to my partners, but I think the buy-sell agreement undervalues the patient records. Although my partners empathize with me, they will not pay me any more for the records than required. Do I have any other recourse?

**A.** A buy-sell agreement is designed to ease the transfer of ownership and ensure marketability in case of retirement, death or disability. It may not reflect true market value.

Talk to your partners. If the valuation formula is flawed or the agreement dated, they may be willing to negotiate. If not, you may have to litigate.

#### PRIOR SERVICE: DOES IT ENTITLE AN ASSOCIATE TO A PURCHASE DISCOUNT.

**Q.** A couple of years ago, I hired an associate. It has been an excellent relationship. The doctor works hard. We are compatible and the practice has grown.

My associate would make an excellent partner and I want to exercise the buy in option contained in our employment contract. We are negotiating, but my associate thinks his prior service should entitle him to a buy in discount.

He says that since he helped grow the practice, he should get some consideration for his contribution to the value of the patient records. Is this reasonable?

**A.** Although your associate may be an excellent clinician and a strong practice builder and patient manager, I don't believe he is entitled to a buy in discount.

Your employment agreement guaranteed him a set compensation package together with a buy in option. It didn't offer him a buy in discount as a reward for meeting the terms of the agreement. His reward is promotion to partner.

#### DIVIDING INCOME IS EASIER THAN YOU THINK.

**Q.** Another solo doctor and I would like to merge our practices. We have agreed on all of

the merger terms except how to divide income.

I want to divide income according to productivity. My prospective partner favors equal distribution. Can you suggest an equitable income-sharing formula?

**A.** If your goal is practice expansion, your income formula probably should emphasize productivity. If the goal is team building, equal distribution could be more appropriate.

The obvious advantage of equal distribution is simplicity. However, equal distribution does not compensate a doctor for his management skills nor does it spur productivity. Conversely, production distribution promotes competition and may be divisive.

Instead of a traditional income-sharing formula, you could combine a base salary with a productivity bonus and incorporate an incentive plan. Compensate each partner for his investment in the practice. Complete the model with a strong fringe-benefit package.

### WHAT IS IT? INDEPENDENT CONTRACTOR OR EMPLOYEE?

**Q.** My partner and I decided to hire an associate doctor. The associate will work full time; receive a base salary and a fringe-benefit package including a performance bonus as well as a continuing education allowance and professional liability insurance.

The associate will sign a two-year contract with a restrictive covenant and non-solicitation agreement.

Is our new associate an employee or is he an independent contractor?

**A.** In my opinion, your associate is an employee not an independent contractor.

Revenue Ruling 87-41, 1987-1, C.B. 296 sets forth 20 common law factors that determine employment status. Control is the most important factor. Is the person who provides the service subject to the will and control of the employer? If so, the worker is an employee.

If your associate works exclusively for you, he is an employee. If you pay his professional liability insurance and provide continuing education benefits, he is an employee.

A doctor who has a two-year employment agreement is likely to be an employee; a doctor who works per diem is likely to be an independent contractor. If your employment contract contains a restrictive covenant, the associate cannot make his services available to the general public and, therefore, he is an employee.

The question of worker status is a difficult one. When in doubt, be conservative; classify your associate as an employee.

The tax advantages of independent contractor status pale compared to the risk of a worker status audit and the penalties you will incur if your associate is classified as an employee.

This is a very difficult and complex tax problem. Discuss this matter with your CPA.

## **PRACTICE BROKERAGE**

### THE ALLOCATION OF THE PURCHASE PRICE IS A TAX QUESTION, NOT A VALUATION ISSUE.

**Q.** In two years, I want to sell my practice and retire. What can I do to minimize the tax consequences of the sale? The practice is not incorporated.

**A.** The sale of a practice is not one sale, but a series of sub-sales. For tax purposes, the purchase price must be allocated to each asset. Gain or loss is computed and each asset is taxed individually.

In order to minimize taxes, allocate as much of the sale proceeds as you can to assets such as patient records which will be taxed at capital gain rates and the balance to assets such as equipment, office furniture, that will be taxed at ordinary income tax rates. Since individual income tax strategies as well as the provisions of The Internal Revenue Tax Code are complex and ever-changing, review tax questions with tax professionals.

### KICK THE TIRES.

**Q.** I would like to sell my general dental practice and teach.

I met a doctor who I think is a good prospective buyer for my practice. I sent him a copy of the practice appraisal, tax returns and office lease. He reviewed the information and would like to schedule an on-site visit to the practice.

Although I agreed to meet him, what should I do when he gets here?

**A.** Since the purpose of your initial meeting is to determine if you and the buyer are compatible and if he and his family like the practice and the community, help him gather information that will enable him to make these decisions.

Conduct clinical rounds. Examine the patient charts and records. Reviews recall procedures. Discuss your discharge plan; recall program and patient-reactivation protocol.

Take the doctor and his wife on a tour of the community. Introduce them to business and civic leaders. Look at schools. Talk to them about cultural events. Introduce the doctor to other dentists and health-care professionals.

When the doctor returns home, follow-up and arrange for him to make an in-service inspection of the practice. The in-service inspection is conducted when the office is open for patient service. The purpose is to let the buyer observe you diagnose and treat patients and watch the staff at work.

If the practice passes the in-service inspection, ask the doctor to sign a confidentiality agreement and provide him with practice specific financial documents such as day sheets, accounts receivable ledger, payroll records, general ledger et cetera and begin sale negotiation.

### PURCHASE OF STOCK V. PURCHASE OF ASSETS.

**Q.** Three years ago, I hired an associate. The associate contract contained a buy-in option. The doctor would like to exercise this option and I want to retire.

The practice is a C corporation. I want to sell the capital stock of the corporation and pay capital gain tax on the gain over basis. The buyer doesn't want to buy stock. She wants to buy the assets of the practice. Why?

**A.** Two reasons. First, if the buyer purchases the capital stock of your corporation, she will be subject to existing or potential corporate liabilities. Although you can indemnify her against loss, you cannot eliminate the risk.

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Second, capital stock is not depreciable. Assets are. If the doctor purchases the capital stock of your corporation, it is not to her advantage tax wise.

If you sell her assets of the corporation, the corporation pays income taxes on its gain over basis and, then, when it distributes the sale proceeds to you, you pay ordinary income tax on your gain-over-basis.

This is a difficult and complex tax problem. Discuss this matter with your CPA.

## **PRACTICE MANAGEMENT CONSULTING**

### ADD A PRACTICE, NOT AN ASSOCIATE.

**Q.** I am a 48 year old solo internist. Last year my practice generated collections of \$425,000. I want to continue to grow, but I am at my maximum clinical capacity.

Dr. HB, a 63 year old doctor, conducts a \$240,000 general practice 4 miles from my office. He would like to sell his practice, work part time for two years and then retire. Should I buy his practice and hire him as an associate?

**A.** If the doctor is clinically compatible and shares your values and practice philosophy, he could provide the coverage and patients you need to expand.

Visit his office. Observe his practice style. Conduct clinical rounds. Discuss his personal and professional goals. Make sure you and he are on the same page.

If yes, buy his practice and merge his office into yours. Offer him a fair compensation package and, when he retires, hire an associate.

### CAN MY OFFICE LEASE VIOLATE MEDICARE ANTI-FRAUD AND ABUSE STATUTES.

**Q.** I have been in practice for about ten years. Recently, I relocated my office to "doctors' row" which enabled me to market my clinical services to other physicians. Forty doctors now refer patients to my practice.

I lease a large office and want to sublet space to a physician who is the largest referent to my practice. I also want to sublet space in this doctor's satellite office.

My attorney said the sublet agreement must comply with the safe-harbor provisions or I will be in violation of anti-fraud-and-abuse statutes. Please explain what that means.

**A.** Anti fraud-and-abuse statutes prohibit any kind of payment that might induce a doctor to refer a Medicare/Medicaid patient to you or enable you to perform any service paid for by Medicare or Medicaid.

For example, if you rent office space from a referent at above market rent or lease space to a doctor who refers to you at below market rent, you are in violation of the statute and may face prosecution.

However, the statute does contain safe harbors that describe specific transactions exempt from criminal or civil penalties.

One safe harbor speaks to rent. First, you must have a written lease. Second, the lease term must be for at least one year. Third, the lease should specify the hours or days you the space and fourth, the rent must be consistent with fair market rent.

In order to qualify for exempt status, a landlord or a tenant must meet each provision of the safe harbor and document that the lease meets the fair market test. If rent is based on utilization not fair market, you probably will not receive safe harbor protection.