

# Contracts, Part I: Partnership/Shareholder Agreements and Employment Contracts

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**In today's litigious society, contracts can be a critical tool to reduce exposure to litigation for ObGyns. This article addresses internal agreements (employees and shareholders), and a succeeding article will deal with external agreements (payers and vendors).**

## SHAREHOLDER AGREEMENTS VS ORGANIZATION DOCUMENTS

If you are in partnership or share corporate ownership in your practice, a partnership or shareholder agreement is a highly recommended legal document. This agreement is a binding legal contract between the shareholders of a practice and can cover a number of key components that you may find are critical to the long-term success and continuation of your practice. While a buy-sell agreement may involve either shareholders or partners, depending on the entity type, for simplification we will use the term "shareholders" henceforward in this article.

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It should be noted that the relationships between the shareholders and the practice are regulated by the organization documents of your practice (ie, Articles of Incorporation, etc.). These define the existence of the practice, regulate its structure, and specify control of the practice and its members.

For ObGyn practices, it is a good idea to supplement the organization documents with a shareholder agreement. There are a number of reasons why, including greater flexibility in the event of changes and ease in removing minority shareholders.

Speak with your attorney about any risks associated with putting a shareholder agreement in place in your state, including unintended liability or tax consequences.

Shareholder agreements vary enormously, depending on the needs of the shareholders. Typical portions of many agreements include: capital contribution requirements, regulation of ownership and voting rights, control and management of the practice, restrictions on transferring shares, majority voting requirements, provisions for dispute resolution, and the buy-sell clause. Most of these provisions are somewhat standard. Others require intense review and development by the shareholders in order to properly reflect

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their intentions. The last issue, the buy-sell clause/agreement, assesses the financial value of the practice and is often the most litigated portion of shareholder agreements.

## BUY-SELL AGREEMENTS

### FOCUSPOINT

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A buy-sell clause in a shareholder agreement (it can also be a separate agreement) is a binding contract between shareholders regarding the future ownership of the practice. The intent of the agreement is to provide for the continuity of ownership, future continuation of the practice, and to ensure that everyone involved (buyer and seller) is fairly treated.

Ownership interest in your practice may be your largest financial asset. Due to the legal and tax implications, it is important to seek qualified tax and legal advisors in this process to ensure that your goals and objectives are met

in structuring your buy-sell agreement. Buy-sell agreements should deal with at least 5 primary issues:

**1. Who can buy a departing shareholder's share of the business:** The buy-sell agreement might stipulate limitations as to whether purchasers may include outsiders or be limited to other shareholders. Of course, state and local laws may apply to your medical practice as to ownership interests. For example, in California, owners of medical corporations must be physicians.

**2. What specific events will trigger a buyout:** "Trigger events" may include death, disability, or retirement, as well as shareholder disputes and personal reasons. These trigger events should be developed and reviewed, in part because they may be considered in how the practice is valued under each scenario.

**3. Whether life insurance or other funding vehicles will be utilized:** Business succession specialists often recommend that a buy-sell agreement should be funded, at least partially, with life insurance (on the participating shareholders), since having potentially millions of dollars in cash

on-hand is unlikely for the remaining shareholders (assuming death of the other shareholder). Instead, if the buy-sell arrangement is funded by life insurance, it can guarantee there will be money in the event of death. If a life insurance policy is desired in order to fund the buy-sell agreement, a valuation will likely be necessary in order to purchase the policy.

**4. The valuation process:** To determine the purchase price for a shareholder's interest in the practice, a valuation process should be used. Depending on the shareholders' wishes, the value can be a fixed price, a formula process, or a specific valuation by which it is agreed the value will be determined.

A fixed price value is typically set at the time of enactment of the buy-sell agreement. This may be a mistake because what may have seemed fair years ago may actually be arbitrary or completely over/under the actual market value at the time of the trigger event. Some practices handle this issue by agreeing to a value and updating their buy-sell agreement on an annual basis.

A formula process usually uses a simple formula, such as the net book value of the cash basis assets plus the collectible accounts receivable. However, as simple as it may sound, such formulas can lead to serious disagreements in arriving at a value. Numerous issues arise in the use of simple formulas, most of which were never considered at the time of enacting the buy-sell agreement.

A specific valuation process helps to alleviate some of the problems mentioned above. Valuation experts are used to determine the value of the practice at the time of the trigger event, not prior to it. Even in this process, there are numerous methods used to value a practice. Three of the most common include market valuation, income valuation, and asset-based valuation. Each has its own set of pros and cons, which your business valuation professional will explain as it pertains to your practice.

**5. The process (plan) under which the practice will be purchased:** A buy-sell agreement is often established in the form

of a cross-purchase plan or a repurchase (entity or stock-redemption) plan. A cross-purchase plan is when surviving shareholders purchase pro rata shares of the deceased owner's stock from the estate. Under a stock redemption purchase plan, the practice is obligated to purchase the stock of a deceased shareholder.

## EMPLOYMENT CONTRACTS

An employment agreement is a contract between the employer and the employee, typically enacted when the employee is hired. Keep in mind that shareholders of medical corporations are actually employees of their corporation and as such, should have an employment agreement.

Some ObGyns find it useful to have employment agreements for many reasons, such as clarifying expectations, avoiding misunderstandings, and specifying key employment and legal matters. While there is no such thing as a standard employment agreement for all ObGyns, much less all medical practices, it is useful to look at the typical sections. For the purposes of this article, we will describe these as: Compensation, Benefits, and Duties; Non-Disclosure and Non-Compete Covenants; and Other Litigation-Related Clauses.

## COMPENSATION, BENEFITS AND DUTIES

There are typically many subsections within this section of the contract, which may include compensation for work

performed, position, duties, required hours of work, vacations and holidays, fringe benefits, and termination. A multitude of compensation formulas exist and selecting the right method appropriate for your practice is important for future peaceful coexistence.

## NON-DISCLOSURE AND NON-COMPETE COVENANTS

Non-disclosure clauses protect trade secrets from being utilized by employees after they leave the practice. The term "non-compete" means that the employee shall not own, manage, operate, consult, or be employed in a business substantially similar to or in competition with the present business. Depending on where you practice, the laws regarding enforceability of such clauses vary.

## OTHER LITIGATION-RELATED CLAUSES

These clauses may include, among others: assistance in litigation, limited effect of waiver by practice, severability, settlement by arbitration, assumption of agreement by practice's successors and assignees, and oral modifications not binding. As with every aspect of the employment agreement, your attorney will have either standard language for these sections or draft it as appropriate for your practice's needs.

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