PART THREE

Group practice: Sharing pay, control, and other stuff

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GROUP PRACTICES need to consider compensation allocations, decision-making control, dispute resolution mechanisms, employment of family members, and real estate ownership.

ALLOCATION OF COMPENSATION

Compensation, bonuses, direct business expenses, benefits, and insurances are usually allocated in one of five ways: (1) by the respective collections or productivity of one owner as a percentage of the collections or productivity of all owners, whereby operating expenses may or may not be equally shared; (2) by pro rata ownership percentage; (3) by administrative and management responsibilities; (4) by the number of days or half days worked; or (5) by a combination thereof.

It is common to calculate yearly or quarterly compensation by the sum of the available compensation multiplied by a percentage, the numerator of which is the percentage of the respective owner's collections as a percentage of all owners' collections, and the denominator of which is the collections of all owners. Operating expenses are not usually equally allocated but paid by the practice. The result is that the owner is paid profit equal to the percentage of owner collections for which the owner is responsible. For example, if Dr. Senior collects 60% of owner collections and Dr. Junior collects 40%, Dr. Senior receives 60% of the profit and Dr. Junior receives 40% (table 1).

However, if operating expenses are allocated equally to owners on the basis of ownership, profits are still distributed as a percentage of the collections of the respective owner as a percentage of the collections of all owners. The result is much different for the owner(s) with the lowest collections than for the owner(s) with the highest collections. In Table 1, practice collections are $2,000,000, owner profit in all forms is 40% of practice collections, Dr. Senior's collections are 60% of owner profit, and Dr. Junior's collections are 40% of owner profit. Where overhead is equally allocated, Dr. Senior receives 75% of the owner profit, and Dr. Junior receives 25%.

An alternative to an equal overhead allocation is to allocate 60% of owner compensation on the basis of respective collections and 40% to ownership. The compensation allocations include hygiene and associate profit. Either way, monthly or biweekly draws, direct business expenses, insurances, and benefit costs are subtracted from the yearly or quarterly profit allocation.

Irrespective of the compensation allocation used, an example should be attached as a schedule to the shareholder employment agreements or multimember operating agreement and agreed to by the CPA for the practice. Without the CPA's involvement in the compensation calculations, profit may be distributed differently than the formula agreed upon, which can cause a significant dispute when discovered at a later date.

DECISION-MAKING CONTROL

Decision-making control can be equally allocated among the owners or vested in one owner or more under a particular state's close corporation or shareholder agreement statutes. Only a handful of states have such a statute in effect.[1] In the states that do, Dr. Senior can avoid the necessity of retaining a 51% ownership interest in the practice for maintaining control or the use of a separate class of stock for voting and nonvoting interests. If the practice operates in a corporate format under such a statute, operational control or the "tie-breaking" vote can be vested in Dr. Senior as long as Dr. Senior owns at least one share of the professional corporation's stock. Future voting control can also be allocated to the other owners on the basis of seniority or by some agreed-upon method. For those practices operating as limited liability companies, management control can usually be allocated in accordance with the operating agreement, depending upon the state.

Table 1: Practice versus pro rata overhead allocation

	PRACTICE PAYS OVERHEAD				PRO RATA OVERHEAD			
Category	Dr. Senior		Dr. Junior		Dr. Senior		Dr. Junior	
Practice revenue	$2,000,000		$2,000,000		$2,000,000		$2,000,000	
Overhead at 60% of revenue	– $1,200,000		– $1,200,000		– $1,200,000		– $1,200,000	
Available compensation	$800,000		$800,000		$800,000		$800,000	
Owner revenue percentage	x 0.6		x 0.4		x 0.6		x 0.4	
Owner revenue	$1,200,000		$800,000		$1,200,000		$800,000	
Overhead allocation	N/A		N/A		– $600,000		– $600,000	
Owner compensation	$480,000		$320,000		$600,000		$200,000	
Owner compensation as percentage of available compensation	$480,000	= 60%	$320,000	= 40%	$600,000	= 75%	$200,000	= 25%
	$800,000		$800,000		$800,000		$800,000	
Owner compensation as a percentage of practice revenue	$480,000	= 40%	$320,000	= 40%	$600,000	= 50%	$200,000	= 25%
	$1,200,000		$800,000		$1,200,000		$800,000	

Assuming that the associate buy-in is internally financed, Dr. Senior may choose to retain decision-making control. Dr. Junior's position may be that even though the buy-in has not been paid at the time of becoming an owner, internal financing is merely a method of payment and has nothing to do with the interest being purchased. A solution is that Dr. Senior should maintain decision-making control until the buy-in has been fully paid. However, certain decisions should require the unanimous consent of all owners, such as the hiring of an additional dentist or specialist, expenditures over a threshold amount, relocation of the practice, and/or the acquisition of an additional practice. After the buy-in is fully paid, decision-making control is equal, assuming that dispute resolution mechanisms are built into the shareholder or operating agreements. If not, Dr. Junior should expect a "lack of control" discount on the buy-in price.

DISPUTE RESOLUTION

Dispute resolution mechanisms can be built into the buy-sell agreement(s) or be freestanding, and they should provide for who leaves and who stays in the event of an irreconcilable dispute.

For family practices, such as those of husband and wife dentists where a nonfamily dentist has been admitted, the agreements may provide that so long as the nonfamily owner has fully paid for his or her pro rata interest in the practice, the nonfamily owner may elect to leave, retain the charts and records of those patients customarily treated, and be paid only for an undivided interest in the tangible assets. While restrictive covenants remain in effect for practice patients, they would not apply to those charts and records retained by the departing owner. Here, patients must be allocated separately to owners. This dispute resolution mechanism is not applicable to specialists due to the nature of referral relationships.

There should be no windfall for a newly admitted owner to leave early. For early departure, the new owner's buyout may be reduced by any unpaid buy-in price and possibly 50% of the buyout formula for Dr. Junior breaking the obligation to buy out Dr. Senior. If, on the other hand, Dr. Senior desires to terminate Dr. Junior's employment without cause or for no specific reason, Dr. Senior may pay a premium to Dr. Junior (e.g., 150% of the buyout formula). The payment terms should also be specified and may vary depending upon the triggering event.

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For successful group practice longevity, the shareholders, members, or partners should commit to holding regularly scheduled board, member, or partner meetings with a written agenda to discuss practice business. Further, a yearly meeting should be held with the CPA and attorney for the practice to review operational results for the most recent year and update the practice strategic plan for the upcoming five years with emphasis on the next succeeding year.

Another dispute resolution mechanism is a buyout of the restrictive covenant as part of the buy-sell agreements and the associate employment agreement prior to Dr. Junior's ownership. This mechanism solves the problem of Dr. Junior having grown up in the geographical area where the practice is located. Any termination of restrictive covenants may or may not allow Dr. Junior to hire specific staff or another dentist.

EMPLOYMENT OF FAMILY MEMBERS

When Dr. Senior is the only owner, the employment of family members, such as Dr. Senior's spouse or child, works well. In a group practice, employment of family members should always be discussed and agreed upon in advance. With regard to the buy-in and later buyout of a family member as a dentist, treat the family member as if he or she is unrelated.

THE REAL ESTATE

If Dr. Senior or Dr. Senior's spouse owns the practice real estate, Dr. Senior may desire to retain 100% ownership. However, maybe Dr. Junior should own a pro rata percentage of the real estate equal to the percentage of the practice being purchased. The rationale is that if Dr. Junior is a partial real estate owner, Dr. Junior has "golden handcuffs" to an extent and is less likely to leave the practice. In addition, the real estate ownership for Dr. Junior provides Dr. Senior with the remaining real estate buyout when Dr. Senior retires. It is also a matter of fairness to allow Dr. Junior to share in the real estate profit. The hurdle for Dr. Junior is to obtain a 20% down payment, as the real estate interest is typically payable in cash but can also be financed by Dr. Senior.

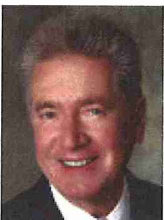
There may be an option or right of first refusal for Dr. Junior to purchase an interest in the real estate or a 100% requirement at some point. The purchase price is determined by a mutually agreed-upon commercial real estate appraiser with Member Appraisal Institute (MAI) credentials. If the parties cannot agree upon an appraiser, each party selects an appraiser, and the appraisals are averaged. If the appraisals are more than a specified percentage apart (e.g., 10%), each appraiser selects a third appraiser whose appraisal is final and binding. Should Dr. Senior desire to accept an offer to purchase the real estate, Dr. Junior should be given a right of first refusal to match the offer within a short time period.

If the real estate interest is not offered to Dr. Junior, there should be a lease in place with a sufficient term and renewal options for the owners to continue to practice in the same facility. It is very difficult for Dr. Senior and unfair to Dr. Junior to increase the rent when Dr. Junior has just been admitted as an owner of the practice.

Dealing with all aspects of practice operations correspondingly decreases the risk of an expensive, time-consuming, and emotional group breakup. **DE**

REFERENCE

1. Statutory close corporations permitted in some states. https://www.bizfilings.com/toolkit/research-topics/running-your-business/statutory-close-corporations-permitted-in-some-states. Accessed February 16, 2017.



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