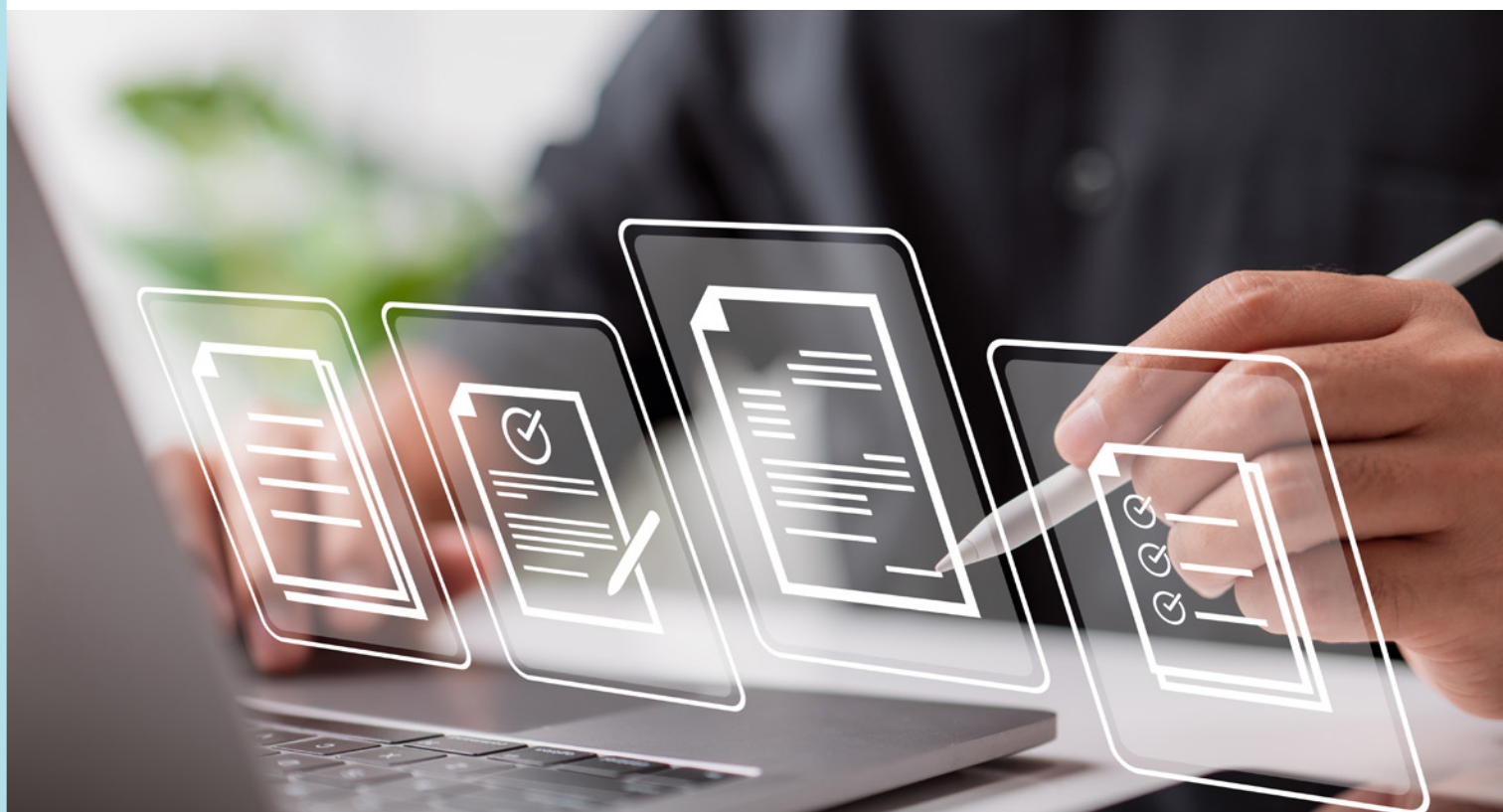




ESSENTIAL STEPS TO SMOOTH PRACTICE GOVERNANCE

BY REBECCA FARRINGTON



Most radiology groups have certain governing documents in their files, but the extent to which the terms of those documents are followed could have a big impact on the success of the practice. Such documents include the ones that describe the formation of the entity, its operating rules, its buy/sell provisions, and its employment agreements. Careful drafting of each one, and then an overall review to be sure there are no conflicting terms among them, will assure the group that they are ready to efficiently handle governance and management issues that might arise.

These important documents can be divided into two broad categories



OWNERSHIP



OPERATIONS



OWNERSHIP

Entity Formation Documents

A formation document is legally required for every business entity, whether it is a for-profit corporation, a non-profit corporation, or a limited liability company (LLC). Depending on the type of entity, the document might be called a Certificate of Formation, a Charter, or Articles of Incorporation.

Each state has its own requirements for filing with the Secretary of State to create the entity.

The formation documents contain basic information about the company, which varies from state to state, such as:

- The name of the entity (prior to application, one must verify with the Department of State that the name is available for use)

- The name and address of the person or persons forming the entity
- The name and address of the Registered Agent, who is the person responsible for receiving any official legal information from the state. This could be one of the founding members or the group's attorney.
- The names and addresses of the Board of Directors
- The type of structure. For a corporation, whether it is for-profit, non-profit, or non-stock
- Specifications about the stock the corporation may issue, including the maximum number of shares, whether the stock is voting or non-voting, and whether it is common or preferred stock.
- The duration of the entity if it is not permanent.



OPERATIONS

Entity Governance Documents

The governance document that outlines how the entity will operate is called the Bylaws of a corporation, or the Operating Agreement of an LLC or partnership. **State laws govern the minimum requirements of these governing documents but generally, they include:**

- The rights and responsibility of the entity's members.
- How and when members will meet, at a minimum annually.
- How members will be notified about a meeting. Today this could be via email, although many older documents still specify postal mail.
- How votes are cast and counted, including what constitutes a quorum. This is another area that has changed over time. Some older documents might limit voting to in-person or by telephone, whereas today they could include email or a virtual online presence.
- How members will be disciplined when necessary.
- How membership can be revoked or rescinded. This can also be covered in more detail in the Buy/Sell agreements.

- The titles (not the names) of the officers. Most states specify a minimum of two officers, the president, and the secretary.

The officers are named in the minutes of the Annual Meeting at the time they are elected. Many practices identify all the owners who do not hold another office as a 'Vice President' in order to reduce their workers' compensation insurance premium.

- How often the officers are elected and the length of a term in office.
- How the Board of Directors is elected, its structure, and its operation.
- The type of decisions that are reserved for all members to decide, and those that are delegated to the Board of Directors.

Board of Directors

This body is the key to the ongoing operation of the practice. In a small group, all the physicians are often on the Board but in a large group that becomes unwieldy. When the Board is a subset of the full membership, the board members should be indemnified in the



Buy/Sell Agreements

A corporation will generally have a Shareholders' Agreement or Stock Purchase Agreement, whereas an LLC or partnership will typically have buy/sell provisions woven into its Operating Agreement.

Either way, the documents define the purchase and sale of a member's interest in the company. The form is not dictated by state law, but the document and its terms should be crafted carefully by an attorney familiar with medical groups. **Terms that are usually found in these agreements include:**

- Definition of the events that trigger operation of the agreement, whether voluntary or involuntary, such as termination of employment for any reason. Other reasons that might trigger a mandatory sale of ownership include bankruptcy, loss of professional license, loss of privileges due to a sanction, a supermajority vote of the other owners, or death of the owner.

- Definition of who has the right or obligation to purchase an ownership interest. In a medical practice, only another medical professional may be an owner and, in most cases, must be an active employee of the entity.
- The mechanism for establishing a value for the ownership interest.
- The payment terms and timing of payments.

It is especially important that buy/sell agreements work in concert with Employment Agreements with regard to termination provisions. There are income tax consequences to both the entity and the individual if they are not coordinated. For example, the purchase of ownership shares (stock or a membership interest) under a buy/sell agreement will result in non-deductible payments by the entity whereas the payment of deferred compensation under an employment agreement will be deductible.

governance document from liability for any reasonable actions they take. In some cases, Directors and Officers Insurance is obtained.

Within the Board, standing committees are defined in the governance document, but ad hoc committees can also be formed for specific, short-term tasks. If an ad hoc committee becomes permanent, then it must be added to the governance document. The governance document will also define how often the committees meet and what they are authorized to do. Committees make recommendations that are approved or disapproved by the full Board, rather than acting on their own.

Employment Agreements

Each physician in the practice should have an employment agreement, and except in special cases, they all should be identical to each other within a given category. Physicians who are not owners of the practice will have an agreement that is different from those who are owners. There might even be a sub-category of non-owner physicians who are strictly salaried from those who are on the track to becoming an owner and have different compensation and benefits.

There is usually a connection between the employment

of the owners and their ownership interest.

When employment ends for any reason, the ownership interest must be sold; and when the physicians are no longer owners, their employment agreement must change as well if their employment continues.

Deferred compensation is a common mechanism used to recognize an employed owner's contribution to the increased value of the practice over time. The value is usually determined by some formula that fits the group's structure, and it must be done in conjunction with the practice's ownership valuation and sale terms. For a practice with offices, joint ventures, or other assets, valuation is usually based on adjusted net book value, while a hospital-based practice without such assets could use a percentage of prior compensation. There could be a vesting schedule that rewards the owner for more years of contribution to the practice.

There are too many variations to cover here, but the value arrived at is typically paid as deferred compensation over a few years following the end of employment. The payment could be accelerated for certain circumstances such as the death or disability of the former owner, and sometimes life insurance is purchased to cover that contingency.



PUTTING IT ALL TOGETHER

Periodic Review of Documents

It is quite common for group practices to spend a lot of time, energy, and money to create legal documents that are then ignored for years until something happens that causes them to open the drawer and look them over. By that time, it is too late to make any changes if they have become out of step with the current practice and the resulting situation could be disruptive.

We recommend a review of the documents every two years to be sure they are still relevant to the practice's needs. A legal review is also a good idea, as provisions in the agreements could become unfavorable over time due to changes in case law or tax law. Changes can occur from within the practice and among its members, due to generational shifts of mindset and expectations, or the practice might have moved in a different direction, for example adding an imaging center or affiliating with a hospital.

As previously noted, technological changes can impact certain terms in these documents that become outdated.

Technology changes practice patterns, as well. Groups will have to consider how physicians working remotely, perhaps never stepping foot into the hospital or office, are brought into the practice – should they enjoy the same benefits of ownership as the on-site physicians?

The Annual Meeting

Along with a periodic review of the documents, the practice has to follow its terms as it regularly conducts its business. Holding an Annual Meeting, with proper notice, attendance, voting, and minutes, is important for the entity to maintain its legal recognition. The failure to operate as an entity that is separate from its owners could expose the owners to legal consequences if the limited liability shield of the entity is disregarded.

The annual meeting is a good time for an illustration and open discussion by the members of the mechanism to be used when a purchase or sale of an ownership interest takes place.

Too often, retiring physicians have unrealistic expectations about the value they will receive, because they have lost sight of the changing nature of the practice. An annual review of the valuation formula and calculation of the values involved, along with how payments will be made, will ensure transparency, and align everyone's expectations.

This process could highlight revisions that are needed

due to changing circumstances in the practice.

Generally, the valuation methodology for a physician purchasing ownership should mirror the valuation at the time it is sold, although the absolute amount will naturally change over time as the practice undergoes growth or retraction. Incoming owners often pay for their share through decreased compensation until they reach parity with the other owners. This mirrors the payment of deferred compensation at the other end of the spectrum.

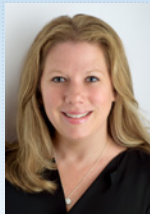
The annual meeting is also a good time to be sure that all of the owners have signed the documents.

As new owners come into the practice, their employment agreement has to be revised to match the changing terms of their employment, and they have to sign on to the buy/sell agreement, in whatever form that takes. In a corporation, the Shareholders' Agreement must be signed by all shareholders, although the Articles of Incorporation and Bylaws are usually not signed. In an LLC or partnership, the Operating Agreement must be signed by all members.

Conclusion

As we have seen, there is a lot of integration of terms necessary among the various documents that form the framework of an entity, and it is important that there are no conflicts among them. Some of these documents, such as Articles of Incorporation and Bylaws, are often viewed as mundane legal requirements and are ignored once they have been initially created. In reality, though, they contain important provisions that might become out of date and can create problems within the group if a dispute arises and their terms are not followed.

Group culture changes over time and that culture has to be reflected in the practice's structure and governance in order to maintain harmony. It pays to schedule a review of the group's documents every two years to be sure they are still relevant to the practice pattern and reflect the group's current thinking. ■



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