OVERVIEW OF VETERINARY PARTNERSHIPS

By Patrick J. Wood, Esq.

The purpose of this article is to provide the readers with a general overview of different types of partnerships that veterinarians use in their veterinary practices, discuss matters that prospective partners should consider before partnering up, discuss various compensation models that veterinary partnerships may wish to consider, provide specific case models from the author and then provide a check list of items that prospective partners should be addressing before forming a professional partnership. A word of caution, do not form a partnership on a handshake!

1. PARTNERSHIP VEHICLES

There are basically three types of entities that may be used for the purpose of forming a veterinary partnership, namely: professional corporation (including professional associations in some states) (collectively "PC's"), limited liability companies, limited liability partnerships, professional limited liability companies and professional limited liability partnerships (collectively "PLLP's"), and general partnerships. Every state will allow the general partnerships and PC's to own veterinary practices, but not every state allows PLLP's to own veterinary practices.

PC's Limitation On Personal Liability. A PC is somewhat different than a regular corporation in that it is only available for use by licensed professionals and generally requires that all shareholders be licensees. PC's must be filed with the state and must continue to provide the state with information as well as paying annual fees. A big advantage of the PC's is that the individual shareholders do not have any personal liability for the actions of others within the veterinary practice, unless it pertains to their individual malpractice or tortious conduct that they commit or allow to occur within the practice. For tax purposes, there are C-corporations and there are S-Corporations. The primary reasons that well over 95% of PC's elect to be S-Corporations is so that the owners can avoid double taxation and pass through income to their individual tax returns.

PLLP's

The advantages of a PLLP are that generally there is no personal liability on the part of a partner, other than for their own tortious conduct, such as professional malpractice. Therefore, the individual partners will not generally be liable for the unauthorized actions of the other partner. The PLLP is operated as a true partnership and does not have to comply with the, sometimes burdensome, corporate requirements. Also, there is no double taxation of a PLLP, unlike a C Corporation. However, not every state will permit a veterinarian to operate within a PLLP.

General Partnerships

General partnerships may be comprised of two or more individual partners or it may have PC's or PLLP's as general partners. The reason the author doesn't recommend that individuals be partners in a general partnership is that all the of partners are personally liable for the actions of other partners. For that reason alone, we recommend that when forming a general partnership, the partners incorporate into a PC or PLLP that then become general partners in that partnership.

Some doctors prefer to only create one vehicle, either a PC or a PLLP, and then have the operating document (Shareholders Agreement or Operating Agreement) for that entity in order to act as the partnership agreement. While this is perfectly acceptable and somewhat less expensive for your lawyer to set up, it deprives the individual veterinarians from simply allocating their portion of the proceeds from the partnership to their entity and then writing that off as they and their CPA deem fit.

2. COMPENSATION MODELS

<u>Collections and Profit Pools</u>
In order to incentivize the partners to work hard but also work as a team to grow and maintain the veterinary practice, one idea is to pay each doctor a standard associate wage based on a percentage of collections from each doctor's production (e.g., 25-35% in a general veterinary practice), with all profits going into a pool to be distributed based on your ownership interest. So, Dr. A collects $500,000 on production, Dr. B $400,000, and if you are using a 25% compensation model, Dr. A receives $125,000 and Dr. B $100,000 as compensation from production. If the veterinary practice is collecting $1,400,000 and it is generating 35% profit (before doctor distributions) for a total profit of $490,000, your profit pool should have $265,000 available to distribute as profits as 50/50 partners, so that Dr. A's total compensation would be $257,500 and Dr. B's would be $232,500.

<u>Collections on Individual Production</u>
Let's say one doctor wants to take more time off and pursue other passions, while the other partner's passion is veterinary medicine and, as a result, puts in more hours at the office. Using this model, you total up collections on each doctor's production and come up with a percentage, and pay out profits based on that percentage. Using the example above where the practice collected $1,400,000, expenses were $910,000 and profits were $490,000, Dr. A who collected 55% of doctor production would get $269,500 and Dr. B who collected the other 45% would get $220,500.

<u>Production Based On Each Doctor Paying Own Production Expenses</u>
This model involves identifying common expenses (e.g., rent, insurance utilities, etc.) and paying them on a 50/50 basis. Other expenses such as staff, lab, supplies, etc. would be paid by the partners based on their respective percentage of total doctor production. Each doctor's total collections would have deducted from it these respective percentages, with the net on each partners' individual collections going to that partner. This can be a complex model to work with due to the difficulty of identifying what are individual expenses versus what are fixed expenses. The theory behind separating expenses is that certain expenses are going to have to be paid regardless of how productive a particular partner is, whereas certain expenses such as

your own personal veterinary assistant, your lab fees and supplies are based upon how much you utilize these resources and, therefore, it can end badly for the doctor who is not very productive, as they could be paying significant fixed expenses.

Profits Split 50/50
Unless you are a partnership that primarily manages associate doctors, this model of splitting profits down the middle doesn't work very well, because it doesn't incentivize the partners financially. Hey, it's a capitalistic system we work in, this isn't socialism. If Dr. B produces 45% of the income year after year, Dr. A will (unless he/she is Mother Theresa or Karl Marx) start to resent doing all of that extra work and not getting paid for it.

3. CASE HISTORIES

Example A
Nearly 30 years ago two fairly recent graduates had the author set them up in a general partnership, with them personally being individual partners. They worked basically the same schedule in this start up practice and split the profits evenly. Against my advice, they decided that they did not want to form either a single PC or form their own PC's as general partners in the PC due to the cost of establishing them and paying associated fees and, thereafter paying the yearly state fees, as well as the additional tax returns.

This form of operating as individual general partners came to a halt some years later when a patient died in their office and lawsuits followed against the partnership and the individual partners. For a time, all of their individual assets were threatened, as they did not know if the malpractice insurance they had would be sufficient should a jury verdict be handed down. As the case was pending, they accepted my recommendation that we dismiss them as individual partners and incorporate them into their own PC's and have the PC's be the general partners of their general partnerships.

These same two individuals now own eight practices through a series of partnerships and individual corporations for each of the practices, and they no longer perform veterinary medicine, but instead manage these offices. They continue to work roughly the same schedule and they continue to split profits on the simple 50/50 basis.

Example B
Dr. A and Dr. B were working together in a practice they had started 20 years before in an upscale part of the country. Dr. A had a serious heart attack and was no longer able to work in the office. He listed his portion of the practice for sale with a reputable broker. The practice was collecting approximately $2,000,000 a year, with the individual doctor's collections being almost identical. They were each making just under $400,000 a year.

Dr. A's portion of the practice was hard to sell because, unlike the traditional process of bringing in an associate and working with him or her for a satisfactory period of time and then transitioning them into ownership, this model was not available to Dr. A. Dr. A who was only in his early 50's, ran marathons and had never smoked, assumed his career was going to continue for many years. The search for a buyer was further compounded by the fact that Dr. B had reasonable approval rights of potential buyers, which he exercised often to bar buyers from acquiring Dr. A's portion of the practice. It seems that Dr. B's income as well as his work schedule has gone up significantly in Dr. A's absence. Finally, only after Dr. A's attorney wrote Dr. B a letter demanding that he reasonably approve the candidates of Dr. A, that Dr. B relented and approved of a buyer for Dr. A's portion of the practice.

The partnership agreement between Dr. A and Dr. B provided that each doctor would receive 30% of their own collections and that all profits would be split on a 50/50 basis. While negotiating with Dr. C, Dr. B wanted to change the partnership compensation model to declare certain items as fixed costs split on a 50/50 basis (rent, utilities, front office staff, insurances, and the like) while making laboratory and personal veterinary assistants a responsibility of the individual veterinarian and then having the individual partner keep what was left over from their own collections. A simple analysis quickly established that unless Dr. C was producing the same amount as Dr. B, his income could be significantly lower, particularly since Dr. B had taken over a large portion of Dr. A's patient load. At this point, Dr. C's advisors counseled him to move on and find another practice, as they were skeptical of Dr. B's ability to share or to even follow the written partnership agreement. By this time Dr. C was in love with the practice (something you should never do when you are a buyer!) and proceeded to acquire Dr. A's interest, with the stipulation that the partnership compensation would remain unchanged from what was in the partnership document. Dr. B agreed and Dr. C closed escrow and started working at the practice.

Approximately six months later, Dr. C called his attorney and said that he was at best doing 40% of the doctor production in the office and said he couldn't understand why this was happening. A consultant was sent to the office to speak with the staff, observe how patients were being allocated, and why. The staff members admitted that Dr. B had been coaching them to put any of the larger cases onto his schedule, justifying that on the basis of Dr. C being a young doctor and not experienced in these types of cases. After being threatened with a lawsuit, Dr. B agreed to a patient allocation program that would call for Dr. C to get all new patients of the practice until he was at, or very close to, Dr. B's production numbers. Unfortunately, Dr. B's shenanigans continued and ultimately an action was brought to dissolve the partnership and sell the practice. The practice was ultimately sold and Dr. B and Dr. C were then made subject to covenants not to compete, which effectively forced them to move out of this resort area to find work.

What could have been done to prevent this? Obviously, Dr. C, after hearing Dr. B's proposal to change the partnership compensation, should have listened to his advisors and not bought into the practice. However, the practice could have been converted into a space sharing situation where the staff was split, with each member working for only one doctor. Operatories could be designated exclusively to the individual doctors, and the phone numbers would have been separated through a system having a phone message saying “for Dr. A and Dr. C, press 1; for Dr. B, press 2”, thereby giving Dr. C a fair opportunity to thrive in the practice. With the staff so separated and operatories designated to a particular doctor, the two doctors would have been effectively operating as two separate veterinary practices within one facility.

4. SUMMARY

It has been said that partnerships are very similar to marriages, and everyone knows that more than 50% of marriages end in divorce. Therefore, before you decide to become partners with somebody you should have a frank discussion with the proposed partner regarding their vision for the veterinary practice and then come up with goals that you each have for making it a success. It is helpful if you have known the proposed partner for a long time, especially if you have worked with the proposed partner at another veterinary practice so that you have some idea of their skill sets, as well as their people skills. You should get a sense for what his or her case acceptance skills are and you should discuss what level of commitment you are each willing to make to the partnership. Are there any work or personal issues that might affect the partnership in a negative way? If so, they should be on the table for each to evaluate. You should also think about what your plan is if the partnership does not work out, i.e., what are the buy-sell rights that the parties are agreeing to? How would the partnership untangle if the partners couldn’t get along with each other? Would the partners have the right to bid upon the buyout price of the other partner, or would it be a blind offer from one partner to the other, with the partner receiving it free to either be bought out or buy a partner out under those terms? You should probably also include a provision where if there is a deadlock that the parties have to sell the practice to a third party, assuming there is a market for it.

As discussed above, an alternative to the separation provisions in the last paragraph would be to convert the partnership into a space sharing arrangement where the staff was split up and operatories were assigned to individual partners, and they operated two separate businesses from the practice. This may be an attractive alternative where there are long term commitments made by the partners on such matters as financing of the veterinary practice, the lease for the practice location, etc. These are all matters that the partners should be discussing long before they make commitments to actually acquire a veterinary practice. They should be doing this with qualified advisors, especially an attorney familiar with setting up veterinary partnerships.

Don’t fall into the trap of putting off going to a lawyer when you set up one of these entities simply to save money, for it will cause you a lot of trouble and money if anything ever goes wrong. Do not rely on a handshake as that unfortunately rarely works in today’s society, and you don’t want to put your economic future at risk by not documenting your agreement with your partner.

Pat is the founder and senior partner of Wood and Delgado, a law firm which specializes in representing medical professionals for their business transaction needs. Wood and Delgado represents veterinarians nationwide and can be reached at (800) 499-1474 or by email at pat@vetattorneys.com or jason@vetattorneys.com.