



Expecting the UNEXPECTED

PLANNING FOR THE POSSIBILITY OF DIVORCE, DISABILITY,
OR DEATH CAN SAVE A PRACTICE IN THE LONG RUN

[By **LARRY N. SMITH, MD**]

Proper planning for a physician's death, retirement, or personal crisis protects your practice, and most importantly, the family of the deceased or disabled associate. I speak to these issues as a disabled physician with Parkinson's disease who, because of proper planning, secured my organization's success and my family's future by having an exit strategy and insurance products in place from the time the practice was founded.

That's why, as many physicians in solo or group practice consider a merger or sale to an integrated group practice, it's crucial to think beyond salary, paid meetings, and vacation time. The doctor and the organization need to consider all the potential eventualities of human frailty, behavior, and the realities of practice life.

In my own experience, having developed a 10-physician multispecialty group that includes

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outpatient surgery, laboratory, audiology, midlevels, and ownership in a 42,000-square-foot building, it was imperative that the realities of bringing new physicians into or getting old physicians out of the organization had to be addressed in detail.

In designing the entry mechanisms for new physician ownership, it became clear that this task was the easiest aspect of expanding the organizational ownership. Cash flow multiples were calculated, equity values determined, buy-in mechanisms discussed, and voting rights transferred to the new member with the purchase of that member's share of corporate stock. Contrarily, it was during this comprehensive examination of the practice's organizational structure that the difficult and sometimes painful reality of removal of an existing physician shareholder became very problematic.

Beginning from that position, the question had to be asked, "Why would a physician shareholder want to leave the practice?" Some of the answers were empirically obvious—retirement being number one. That departure was easiest to structure because retirement dates are generally known years in advance, and the organization would begin recruiting a replacement for the retiring physician 3 to 4 years before the planned retirement date. By starting recruitment early, a suitable new physician who fit into the practice environment could be found and

then buy out the retiring physician's shares. Straightforward enough, but only the tip of the iceberg.

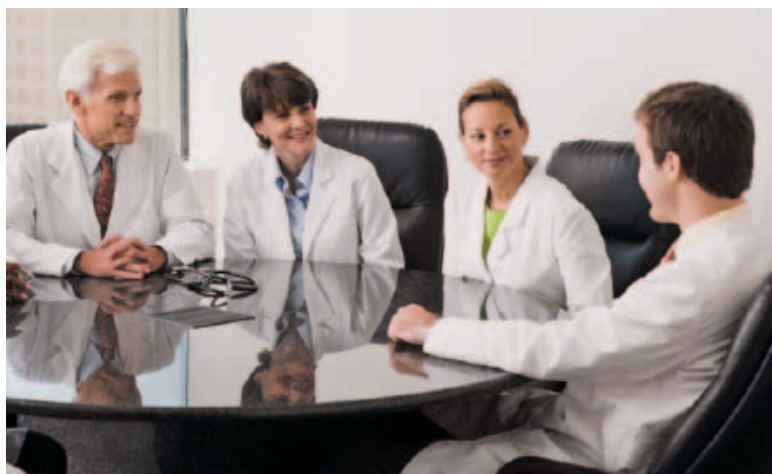
Looking below the surface, it became obvious that a physician may choose to leave an organization for a variety of reasons—some simple, some very painful. It became clear that structuring a successful departure involves more than money. An unplanned departure can include issues of divorce, noncompete clauses, retirement planning, death, and disability. Some of these issues are interrelated and require comprehensive solutions.

DIVORCE ADDS COMPLICATIONS

Divorce presents a particularly difficult problem for the practice, because by nature it creates an adversar-

ial relationship between the divorcing couple and the practice. The spouse of the physician-owner, through an attorney, is determined to be sure that his or her share of the practice, real estate, retirement fund, and other ancillaries are appropriately valued, whereas the practice and the physician owner are trying to ensure that overvaluation models do not come into play. It is for this reason that spouses must sign and understand predetermined valuation models for those aspects of the organization that they will be entitled to a share of in the event of a divorce.

Without this pre-buy-in agreement, the organization faces the risk of nonphysician owners and self-serving overvaluations of those jointly owned assets.



**THE ORGANIZATION NEEDS
TO CONSIDER HUMAN
FRAILITY, BEHAVIOR, AND THE
REALITIES OF PRACTICE LIFE.**

This predetermined model of valuation is important in the event that the divorced physician-owner decides to leave the practice and community because of the experience. This eventuality can be made worse if the physician desires to leave the practice but stay in town and compete. Fortunately, noncompete clauses allow for financial damages but limited geographic restrictions.

Accordingly, requiring the disgruntled departing physician to give up his or her stock and value in the practice for the right to stay and work in the community gives that doctor pause to evaluate just how unhappy he or she truly is. In some cases, however, the practice may need to remove a dysfunctional physician from the organization. If so, it is important that

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by prior agreement the practice will buy out the physician at full valuation with the understanding that the doctor leave the practice's geographic footprint. These issues have to be openly discussed before any agreements are settled. Otherwise, every new physician and every departing physician will be negotiating in their best interests and not in those of the practice. Having a single operating document is imperative.

THE REALITY OF DEATH OR DISABILITY

Death and disability are two of the most important organizational risks that any medical organization may face, yet they generally are the most under addressed and poorly managed when one or both occur.

Over the course of a working American's life, he or she will face a 1 in 5 to 1 in 7 chance of suffering a 5-year or longer disability before age 65, with a 30% risk for needing access to long-term care insurance.

A 37-year-old is three times more likely to become disabled than to die. By age 50, it is a 2 to 1 probability of disability over death with chronic illness a more likely cause than a traumatic injury, according to the Disability Insurance Resource Center, Northwestern Life Insurance Co.

These probabilities only worsen as the number of physician-owners of a practice increase. With three owners aged 45 years or more, a 75% probability exists that one of the three will suffer a disability before age 65. In the same three-person practice, a 50% probability exists of one member dying before age 65, according to New York Life's Probability Calculator.

Understanding these statistics makes planning for these events mandatory. It requires consultation with an insurance agent who can supply comprehensive and properly integrated protection products. Every owner can ask him or herself some simple questions privately, and the answers should be discussed openly in a board meeting. It is important for the corporate owners to understand the interrelation and dependency between themselves and the practice (see sidebar article "Asking the tough questions" on page 45).

The death of an associate is a painful and unpleasant experience that has to be planned for when calmer, less emotional minds are involved. Having already established the valuation model for an associate's share of the organization, a life insurance product is purchased and owned by the practice that covers that value plus an additional 25% to 100% death benefit. The reason for the excess death benefit is that it is wiser to pay the deceased associate's estate an additional 10% to 20% more than the calculated value to prevent any litigation over valuation. This effort potentially will save the organization litigation costs. This excess death benefit also will cover any accounts receivable due the estate and will provide the organization operating income that is lost due to lost productivity.

The insurance product's premium also must be integrated into the disability policy with a waiver of premium rider for the life insurance and a whole life conversion option at any time regardless of health status in the event of disability.

With disability comes a plethora of issues that are best managed with a comprehensive insurance package. The organization needs to have both short-term and long-term disability insurance products available for its employees and owners. The individual may chose to have additional life and disability insurance products outside the organization. This is an individual decision, but the organization's group short-term disability should be integrated into a comprehensive long-term disability policy with waiver of premium and cost-of-living allowance benefit riders.

An office overhead disability policy also needs to be added, covering the associate's absence and decreased productivity for at least 2 years with total benefits of at least \$250,000. Then, in the event of total disability, a disability buy-out policy is needed to cover the valuation of each associate's share so that the organization can dissolve its financial obligations to the disabled associate equitably and efficiently.

The important issue of long-term care (LTC) insurance also has to be considered. Given the risk for utilization of a LTC facility during a disability and

POWER POINTS

An exit strategy and insurance should be in place from the beginning.

Protect the practice from partner's divorce through a spousal agreement.

Death and disability are organizational risks that any medical organization may face.

Long-term care insurance can save a practice from dipping into its own funds.

for retirement and estate planning, having access to a LTC product is crucial. The policy can be included in the retirement package of each associate and with a 10-year or by-age-65 payment plan so that the policy can be funded completely, providing financial and estate security for the disabled associate's family while indirectly protecting the organization.

INSURANCE BASICS

The key points in designing, building, and planning for the long-term success of a medical organization hinge on addressing upfront all the unpleasant eventualities that can occur throughout an individual's life. A uniform, predetermined valuation model coupled with life, group short-term and long-term disability, office overhead disability, disability buy-out, and LTC insurance products with cost-of-living allowance, waiver of premium for life and disability policies, and whole life conversion is the minimum that should be included in the organizational structure. Having those components in place protects the organization and an associate's estate and family in the event of the worst-case scenario. With cost-of-living adjustments, a disabled associate will be able to keep his or her family's lifestyle stable. With the waiver of premium benefit, the associate will be able to assume the ownership of the life insurance product from the practice on his or her departure, and it may be possible to extend this benefit to the LTC and office overhead policies, depending on the practice.

Whole life conversion at any time, regardless of health status, is a critical component that allows the disabled associate to convert his or her term life policy into a product that can provide additional income and security to the physician's family. The risk for owning a permanent whole-life policy with waiver of premium benefit helps the disabled associate if at some point he or she decides to take the dividend paid to the policy instead of reinvesting it. This dividend payment may be as much as \$50,000 a year.

Some very basic and important realities have to be considered before forming or joining any medical organization. If exit strategies are not planned for, individuals within the organization will be reaching into their own pockets and bank accounts to pay for these easily managed problems that now have become burdensome financial obligations that can lead to the dissolution of an organization.

PREPARATION PAYS OFF

Shortly after my departure from the practice, an associate had metastatic cancer (a common cause for disability and death) diagnosed and underwent treatment; the associate's family also benefited from

ASKING THE TOUGH QUESTIONS

The following are some questions to consider to help prepare your practice for a major life event, such as divorce, disability, or death, affecting you or one of your partners.

- If you were sick or injured in an accident today, how would your family's standard of living be affected?
- How long would your savings last if your income stopped because you were unable to work due to an illness or accident?
- What effect would a long-term illness or injury (disability) have on your ability to continue saving for retirement?
- Would your employer (which is, effectively, your practice) continue to pay your salary if you were unable to work due to an injury or illness? What if the disability lasted several years?
- Could you afford to take a 6-month vacation? If you couldn't, do you think you could afford living through a 6-month injury or illness (disability)?
- During your disability, could you or your family pay for increased expenses resulting from your disability?
- Would you still be able to save for retirement during your disability period?
- Would you be forced to spend your existing retirement savings to support your family during your disability?
- Have you and the practice sufficiently protected the investment that you as an owner currently are engaged in supporting?
- Could the practice survive the financial loss of an associate with a disability lasting 1 or more years?
- Does the corporation have the financial resources and cash flow to buy out an associate due to a long-term disability?

this structure. Within 3 years, the organization used all of the insurance products discussed here. As a result, it cost the organization little except for annual premiums, the total cost of which pales in comparison to the financial obligations that the organization's members personally would have paid.

Proper planning with an eye to the worst-case scenario and the end game pays off when it is needed. **ME**



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