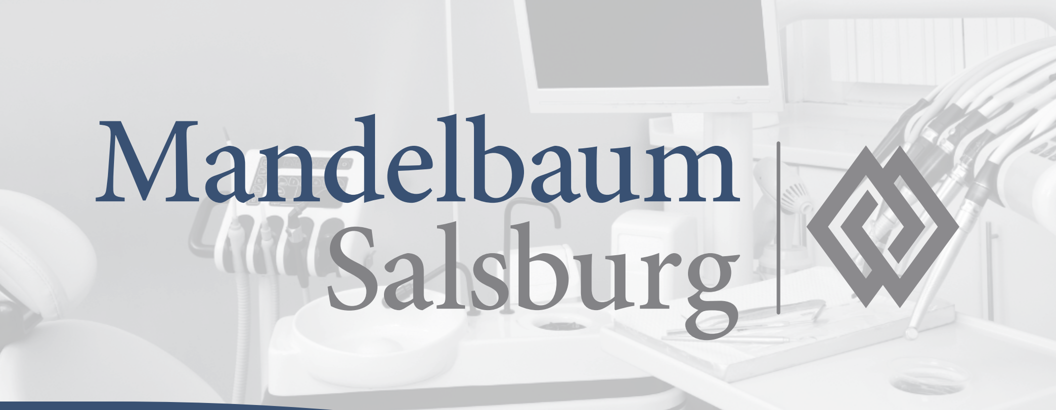

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9 Essential Issues to be Considered by Every Associate “Buying In” to a Practice

There are several stages to the associate buy-in. Typically, the initial stage involves general discussions between the parties about the buy-in. After the parties have agreed in concept about the business terms of the buy-in, these terms are memorialized in the form of a letter of intent. Finally, professionals working on behalf of the parties draft the agreements that incorporate the agreed-upon business terms. These agreements usually require extensive negotiations between the parties. Since negotiating a "partnership" arrangement can get complicated and, sometimes, contentious, the discussions should begin as much as one year prior to the targeted effective date.

In the discussion below, it is assumed that a sole practitioner (hereinafter referred to as the "Senior Doctor") is bringing in a partner (the "Junior Doctor"). It is also assumed that the parties are not actually forming a "partnership"; rather, in most cases, the Senior Doctor's practice is already operating as a legal business entity (e.g., a professional corporation ("PC") or a limited liability company ("LLC")), which the Junior Doctor will buy into, thereby creating a "partnership" between the doctors. If the practice is a PC, then the "partners" will be shareholders of the PC; if the practice is an LLC, then the "partners" will be members of the LLC.

Issue 1: Culture Fit/Philosophy

Ideally, partnerships are long-term. When the arrangement is good, life is good. When partnerships go bad, they can go really bad, just like with marriage and divorce. Before anything else, think hard about whether you share the same professional and business philosophies as the Senior Doctor. Also consider whether you will fit into the practice's culture. Practice ownership is not for everyone. Some associates have no desire to subject themselves and their families to the financial risk and the management responsibilities that come with practice ownership.

Issue 2: Do Due Diligence

Before you decide to buy into a practice, thoroughly review all the documents provided by the Senior Doctor. Don't be shy about asking questions concerning all aspects of the practice: financial statements and patient records, personnel records, financial records, tax returns, bank statements, accounting functions, marketing programs, supply vendor records, leases, important contracts, etc. You will need to understand and justify the practice's expenses during your due diligence. Beware of practitioners who are dangerously free with a dollar. They might run an outstanding practice, but they have a tendency to run cash-poor because the owner has to have every new gadget and every late-breaking diagnostic tool, regardless of whether that equipment generates revenue to justify it.

With the help of a CPA, analyze the practice's tax returns, financial statements and bank statements. Perform trend analysis, not only of revenues, but patient count as well. Carefully review the equipment list. Is the equipment up-to-date or will you have to earmark funds for newer equipment? Is the equipment connected to a lease obligation? These are just some of the questions that you should address during due diligence. The bottom line is, if you are considering buying into the Senior Doctor's practice, you need to thoroughly analyze the inner workings of the practice.

Issue 3: The Purchase Price

The value of the practice for a buy-in is a major hurdle that you and the Senior Doctor must agree upon. It is essential to get a fair market independent appraisal of the practice at the outset to avoid frustration and disappointment with the outcome. It is common for buyers and sellers to get emotionally involved in the negotiations of the purchase price. However, both would do well to remember that open communication is essential for the arrangement. After all, both parties will be working side-by-side for many years, and a positive introduction of a new partner can make all the difference between the success or failure of the new partnership and, thus, the practice itself. Any lingering animosity on either side over a less-than-fair deal can negate all the benefits of a flourishing partnership.

Important factors that are generally considered in valuing a practice are:

1. its location;
2. the ability to effectively transfer goodwill to the buyer;
3. years in existence, and the stability of the practice;
4. demand for the practice's services;
5. the quality of the staff; and
6. the practice's revenue growth.

Issue 4: Structuring the Buy-In and Financing Options

Structuring the buy-in is one of the most important parts of the partnership arrangement. Once you and the Senior Doctor have agreed upon the purchase price and the percentage of ownership interest that you can buy, you must then agree on a structure for the buy-in, including how it will be financed. How your buy-in is financed is a key determinant of your long-term cash flow and, ultimately, your success.

In many cases, the buy-in is financed by the Senior Doctor. This is the result of banks typically requiring a first lien position on the assets of the Senior Doctor's practice. The Senior Doctor will not like this because if you default, then the bank can foreclose on the entire practice, not just your share. In essence, the bank often requires the Senior Doctor to "guarantee" the Junior Doctor's note.

In most cases, you will pay a portion of the initial purchase price – typically 10% to 20% – upfront and pay the remainder over time pursuant to the terms of a promissory note. Where the Junior Doctor pays part of the purchase price upfront in after-tax dollars and then pays the remainder over time, it may be done by way of an income differential. For example, assume that the parties have agreed that the purchase price will be $100,000 for a 10% ownership interest. The Senior Doctor may propose that $10,000 be paid up front and the remaining $90,000 will be shifted from the Junior Doctor's income to the Senior Doctor's income over a five-year period.

Another option for the parties to consider is a "sweat equity" structured buy-in. Sweat equity refers to the Junior Doctor's contribution to the practice in the form of effort. In most instances, the Junior Doctor will be given an initial ownership interest at the closing (e.g., 10%), with the opportunity to receive additional ownership interests over a period of time (e.g., five years).

As in all transactions, tax treatment of the parties must be considered and addressed. In a sweat equity structured buy-in, consider the following:

1. the Junior Doctor will be required to pay ordinary income tax on the "phantom income" he receives because the interest he receives has value for tax purposes;
2. the Senior Doctor will receive capital gains treatment on the ownership interest he sold to the Junior Doctor; and
3. the Junior Doctor will have a cost basis equal to the amount of "phantom income," so that in the future if he were to sell his ownership interest, he would recognize capital gain income only to the extent that the selling price exceeds his cost basis.

By way of example, assume that the parties have agreed that the Junior Doctor will buy a 50% interest in the practice, which is valued at $500,000. Also assume that the Junior Doctor may receive a 10% ownership interest in the practice in year 1 and then a 10% ownership interest in each of the four subsequent years, for a total of 50%. In each of the five years:

1. the Junior Doctor would be required to pay ordinary income tax on $100,000 (the value of the ownership interest he is receiving);
2. $100,000 will be allocated toward the purchase of a portion of the underlying stock or membership units, resulting in the Senior Doctor receiving capital gains treatment; and
3. the Junior Doctor will have a cost basis of $500,000.

There is more than one way to structure and effect a successful buy-in. Much of it depends on the special circumstances of each buy-in. Obviously, the purchase price and the payment structure will have tax consequences for both parties that will need to be considered and addressed.

Issue 5: The Agreements

Once the parties have agreed upon the business terms of the buy-in, the proper agreements will need to be drafted in order to effectuate the buy-in. Typically, these include:

1. the purchase agreement, which sets forth the terms of the buy-in;
2. a "partnership" agreement, which sets forth how the practice will be managed, together with the pertinent buy/sell provisions in the event of a death, disability, retirement or withdrawal; and
3. the employment agreements, which set forth the terms of employment for each of the doctors and how they will be paid for the actual dentistry they perform.

Issue 6: The Purchase Agreement

The Junior Doctor must buy into something, and that something can be a PC, LLC (or professional limited liability company, depending on your jurisdiction) or some other similar type of corporate entity. The corporation's structure must protect both the Senior and Junior Doctors. The purchase agreement will need to address:

1. liabilities arising from the acts of the other dentists in the practice that occurred prior to the actual buy-in (e.g., the closing date) and
2. general liabilities of the practice (such as debt, real property and equipment leases). In addition, the purchase agreement must also address whether you, as the Junior Doctor who is buying in, will be required to guarantee any existing loans or leases.

The purchase agreement will also likely include the following deal terms:

1. Percentage of Ownership Interest. The percentage of interest that the Junior Doctor is purchasing from the Senior Doctor (e.g., 50%).
2. **Purchase Price.** The agreement will set forth the purchase price and describe any adjustments to be made to the purchase price on or prior to the closing.
3. **Loan Contingencies.** If the Junior Doctor is going to obtain bank financing to pay the purchase price, then the purchase agreement would likely include a loan contingency.
4. **Due Diligence.** If the Junior Doctor has not yet had an opportunity to review the practice's financial records, contracts, insurance policies, etc., then the agreement will likely provide for a period of time in order to allow the Junior Doctor to conduct his due diligence of the practice. (e.g., 30 or 45 days).
5. **Representations of the Senior Doctor.** This is one of the most important sections of the purchase agreement. Here, the Senior Doctor will be required to make numerous representations that the Junior Doctor will rely upon (concerning pending litigation, power and authority

of the seller, taxes, compliance with laws and regulations, etc.). As the Junior Doctor buying into the existing practice, you are basically stepping into the existing "DNA" of the Senior Doctor's practice, so this section is critical. Thus, if there are any "skeletons in the closet," you want to have them identified and addressed in the Senior Doctor's representations.

6. **Indemnifications.** As the Junior Doctor buying in, you want to avoid being responsible for any liability arising out of any conduct, acts or responsibilities of the Senior Doctor or the practice that occurred prior to you becoming an owner.

Issue 7: The "Partnership" Agreement

Once the parties have agreed upon the terms of the purchase agreement, they need to agree upon the terms of their "partnership," which is set forth in the parties' operating agreement, if the business entity is a LLC (or professional limited liability company, depending on your jurisdiction) or a shareholders agreement, if the entity is a form of a corporation.

The terms of the partnership agreement will address how the practice will be managed and who will be responsible for the day-to-day operation of the practice. In most cases, the Senior Doctor will desire to retain responsibility for the day-to-day management of the practice. However, the Senior Doctor can require your input for "major decisions" (e.g., issuance of additional ownership interests in the practice, employment of new employees, decisions to incur any indebtedness, selling the practice, relocating the practice, changing the employment agreements, etc.). The agreement should also address exit strategy issues that are set forth in the buy-sell section of the agreement. The parties will need to establish under what circumstances a co-owner (or his or her estate, if deceased) would be forced to sell his or her ownership interest, and on what terms. Upon the occurrence of certain triggering events, the co-owner should be required to sell or offer to sell his or her ownership interest to the remaining co-owner. As part of the process, the partnership agreement must also identify a formula to value the ownership interest and provide for payment terms that will either require the owners to buy insurance to fund a purchase (e.g., life insurance or lump sum buy-out disability insurance) or will specify the length of time for payment of the purchase price (e.g., sixty months) and the rate at which the unpaid balance will accrue interest. It is designed to be mutually beneficial for all parties in order to permit the seller (or, in the event of death or total disability, for his family) to be paid the agreed upon amount over a reasonable period of time. It is also designed to permit the remaining co-owner to continue the practice while paying the seller or his family the value of the ownership interest without causing the practice to fail due to cash flow problems.

Issue 8: The Employment Agreements

Each of the doctors should have written employment agreements, which describe how each doctor will be compensated and what benefits they are to receive. A practice's compensation structure is the most important part of its culture and one of the hardest things to get right and keep right. The employment agreements will set forth how each doctor can be terminated for "cause" (e.g., conviction of any felony, suspension or termination of the doctor's professional license, etc.). The agreements will also set forth the restrictive covenants (e.g., non-competition, non-solicitation and confidentiality) that each doctor must comply with for an agreed upon period of time (e.g., three to five years) in the event their employment with the practice is terminated.

Issue 9: Restrictive Covenants

One issue that will need to be addressed at some point in the negotiation process is whether an owner should be subject to a non-competition/non-solicitation covenant if he or she leaves the practice. The short answer is a definitive "yes." Many co-owners view the restrictive covenant as a negative, but it is important to remember that a restrictive covenant protects the co-owners equally from a departing co-owner competing with the practice. Restrictive covenants that arise as part of a "partnership" agreement are typically deemed enforceable if reasonable in scope (the geographic radius of the restriction) and in duration (the term of the restriction, typically three years or less).

Conclusion

The buy-in transaction has a natural flow and process. The doctors should focus on practicing and let their advisors advise them. At the end of the day, though, you have to make the decision about what's best for you, not what is best for your lawyer or accountant. Remember, communication is vital to the process. After all, the goal is for both parties to work together side-by-side for many years, and the positive introduction of a new partner can make or break the new partnership.

These are just the key issues to be addressed when considering an associate buy-in. Each deal and each practice is unique, so be careful when comparing your deal to others. It is important to engage an experienced dental transactional attorney and a dental CPA who are familiar with the issues to guide you through this important process.

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