



NATIONAL VETERINARY LAW CENTER

11 Essential Steps to Purchasing or Selling Your Veterinary Practice

The attorneys on the Veterinary Practice team of Mandelbaum Barrett, led by Peter Tanella, have represented many veterinarians in the sale and acquisition of practices. In our experience, for all kinds of practices, the same issues typically threaten to kill the deal. We have found that if the buyers and sellers take “11 Essential Steps” in buying or selling a practice, they are likely to enjoy a successful transition.

Step 1: Consider a Letter of Intent

Rather than incurring the expense of negotiating and drafting a contractual agreement, consider entering into a letter of intent (LOI) with the other party. An LOI is a document that outlines the preliminary agreements and understandings between the parties to the transaction. It is not – nor should it be – a legally binding contract; it should simply describe the essential business terms of the deal, including timing, monetary terms, financing, deal contingencies, risk allocation, transition, form of documentation and which party will prepare the documentation. A well-drafted LOI mentally and emotionally commits the parties to the fundamental terms of a deal, increasing the likelihood of the deal's success, and ensuring that a contract will be signed and will close.

Attorneys can use the LOI as a basis to quickly and efficiently negotiate and draft legally binding documentation. Because the parties have agreed in advance to certain key points, less is left open to negotiation, and the chances of the deal falling through are reduced. LOIs are non-binding. In fact, an LOI should specifically state that “the terms contained herein are not binding on either party and are merely intended to be a conceptual understanding of key terms between the parties.” Because attorneys are routinely left out of the drafting process, legal fees and delays can be avoided. However, complex LOIs are sometimes drafted by attorneys; consulting an attorney during the process will ensure that all of the key provisions of the transaction have been considered.

Step 2: Do Due Diligence

Parties generally proceed with their due diligence in one of two ways: (1) prepare a letter of intent with confidentiality requirements and a right to conduct due diligence prior to drafting the contract, or (2) enter into a written contract that provides for due diligence as part of the terms, with a closing to follow upon satisfaction after due diligence. The buyer should satisfy himself or herself during due diligence, by conducting a detailed accounting of the practice assets and an inspection of the premises, assets, inventory, books and records, tax returns, financial statements, client charts, accounts receivable,

personnel files, employment agreements, leases and contracts, list of creditors, insurance policies and benefit plans, and any municipal and other local, city or state approvals required to operate the practice. Involve an accountant and attorney during due diligence. The buyer should run a search against the seller and its principal to make sure there are no liens against the practice assets, such as judgments, tax liens, lawsuits or UCC financing statements that create collateral liens on the property of the seller. Most importantly, during due diligence, the buyer will want to determine the viability of the real estate

lease where applicable, ratify the fairness of the purchase price, verify financial data, be satisfied as to personnel contracts and other

key contracts, verify clear title to the assets, inspect charts and cross-reference them with billings and procedures.

Step 3: Negotiate the Lease

A tremendous amount of goodwill attaches to the location of a veterinary practice. The buyer should not make the mistake of assuming that a lease is good simply because the seller has been in the location for a long time. He or she should request a copy of the lease immediately upon taking an interest in a practice and begin a dialogue with the landlord early in the process. The seller should anticipate a sale and speak upfront with the landlord. We have found that it is usually advantageous for the buyer to be able to negotiate a new lease

directly with the landlord. However, when the seller has already done a good job getting a favorable lease and a term with renewal rights, we can also negotiate a simple assignment. In either case, the two parties will, in most cases, need the landlord's consent to the new tenancy. The buyer's lender will generally require a lease term and/or extension rights to cover the entire length of the loan. If a seller has a short term remaining on the lease, he or she should organize extension rights and clean up the lease relationship before listing the practice.

Step 4: Secure Financing

In the world of business transactions, financing for veterinary transitions is unique, because there are a number of specialty lenders who will often finance 100% of the purchase price, plus, in some cases, additional money for working capital. This has made the market for financing practice transitions very robust. Financing requires a lien on the practice assets, so if the cash flow of the practice can service the debt, cover the practice's expenses and provide enough income for the buyer to pay his or her personal bills, in most cases the lender will fund the deal in its entirety. Typically, the rates are at market and comparable to other

commercial loans, but the terms may vary based on the ability to service the debt, the debtor's credit score and the size of the loan. Loan terms are commonly five, seven or ten years, with equal monthly installments of principal and interest. Since borrowers in the acquisition market expect to receive 100% financing, the lenders often have a say by default in setting the price for a practice during due diligence. Sellers who seek premium pricing are often asked to take back a note and finance amounts in excess of what a specialty lender will lend.

Step 5: Confirm the Zoning Requirements

One of the first legal issues to consider when conducting due diligence on a practice location is whether or not there is a valid certificate of occupancy, and whether local building and zoning ordinances permit its continued use as a veterinary practice. Each municipality has its own zoning rules and regulations. Do not assume that what works or is allowed in one place, will work or be allowed in another. All municipalities make copies of their zoning code and zoning map available for purchase for a nominal charge. Identify the particular “zone” where the practice is located. Once the zone is identified, the requirements and prohibitions that apply to that zone will need to be reviewed. Even if a particular use is permitted in the zone (such as parking requirements), there could be other issues that may affect the use or require a variance to get approval for the intended use.

Most practitioners do not realize that even in the case of the purchase of a long-standing existing practice, variances may still be required for any number of reasons, including but not limited to, a pre-existing nonconforming use that pre-dates the zoning regulations. Such uses can trigger problems upon the transfer of ownership from the existing owner to the new owner. A variance is an order from the municipality granting relief to a property owner from a particular ordinance or restriction. A person or business must apply to the municipality for such relief, which can be a time-

consuming process. Regardless of whether or not a variance is needed or a use is readily permitted, many municipalities require certificates of occupancy and a planning board appearance before allowing a business to conduct its permitted use. These application and appearance requirements allow cities and towns to monitor the uses, occupants and tenancies at any particular location in the municipality. It also gives the governing authority a chance to ask questions about the potential business, the hours of operation, use, number of employees, parking space requirements, and any and all other matters of concern to the municipalities. This “screening” process can be a lead time item and cause delay.

Step 6: Figure out How to Handle Accounts Receivable

There are a variety of ways to manage accounts receivable. The most common are:

- The seller keeps the receivables and the buyer collects them as a courtesy or for a fee
- The seller keeps the receivables and collects it him or herself
- The buyer pays additional consideration and collects the receivables post-closing

Determine early on in the negotiation how much accounts receivable the seller has, and its aging. The seller generally wants the buyer to collect the receivables and pay them over as collected, but the stumbling block is determining who gets paid first. We recommend that the buyer either purchase the accounts receivable for a fair price based on dollar amount and historic collections performance, or he or she collects it for the seller as it comes in as a courtesy or for a small administrative fee. The seller may collect the receivables him or herself, though the buyer risks damage to the practice's goodwill if the seller adopts aggressive methods to chase clients for payment of old bills.

Step 7: Establish Clear Restrictive Covenants

Unlike an employment relationship where courts frown upon overly restricting a person's right to work, when selling a practice, it is reasonable to require the seller to enter into a post-closing restrictive covenant with a substantial time and geography limitation. The seller is receiving significant consideration – the purchase price – and the buyer is acquiring all of the goodwill and, in most cases, taking on significant debt to buy

the practice. So the seller should be prepared to remove him or herself from the marketplace. We recommend a restrictive covenant of five years – and certainly no less than four. Geographic limitations vary depending on location. In suburban and rural locations, the limitation is defined in terms of number of miles, whereas in urban settings, the limitation may be expressed in terms of city blocks or neighborhoods.

Step 8: Determine an Appropriate Transition Period

It will benefit the buyer, seller and clients to have a reasonable transition period – and the arrangement should be agreed upon earlier and included in the

contract. At a minimum, the seller should be willing to answer questions and make introductions to clients, staff and referral sources for zero to nominal consideration.

If the seller is going to continue to treat animals, however, he or she will essentially be an employee and should be paid a percentage of collections. The buyer should reserve the right to terminate the seller if the post-closing chemistry is not working, though this should not be taken lightly. The reality is that sellers generally have worked their entire career

in the practice, are accustomed to being accountable to no one and are sensitive to being treated as an employee, so they may have difficulty taking direction and according the buyer the appropriate respect and deference. The buyer cannot afford to have his or her credibility undermined by the seller.

Step 9: Determine Purchase Price Allocation

The purchase price that is allocated in a practice transition can have significant tax implications for both parties. Typically, in an asset purchase, sellers want to allocate as much of the purchase price as possible toward goodwill since allocations toward goodwill receive capital gains treatment, which is a significantly lower tax rate than ordinary taxable income. Conversely, if allocation is applied

toward furniture, fixtures and equipment (FF&E), to the extent the seller has already depreciated such FF&E, he or she will have to recapture the prior depreciation, which is subject to ordinary income tax treatment at a higher tax rate. Buyers prefer FF&E treatment because they will depreciate the FF&E on an expedited basis and get a faster tax benefit, as opposed to goodwill, which is depreciated over 15 years.

Step 10: Determine Assignable Contracts

During the due diligence process, it is vital that the two parties identify essential contracts in the operation of the practice and decide whether or not such contracts will be assumed by the purchaser. Such contracts may include real estate leases, veterinary practice equipment leases, office product equipment leases, software licenses, maintenance agreements, management agreements, marketing and advertising agreements, personnel contracts and any other contracts for which there are long-term commitments. Such agreements may require prior

written consent from the lessor and credit approval for permitting assignment, which may impact the amount of lead time necessary for closing.

Step 11: Draw Up the List of Assets

Attach an asset list to the purchase agreement detailing all items being purchased as part of the transaction. Alternatively, it may be easier to create a video of assets and attach a disk rather than a list.

Equally important, identify those items that are not included in the closing. Typically, this includes cash on hand, accounts receivable, personal property of the seller, artwork and personal computers.

Once you decide to sell or acquire a practice, these steps, with the guidance of experienced professionals, should help make that time in your career an exciting and positive journey.

Notes



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