Dentistry iQ

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Do An Initial Exam Before Buying a Dental Practice

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A comprehensive dental examination is often the first place to start with new patients.The dentist can examine the patient's teeth and gums, and develop a treatment plan.

It's also smart to apply the same approach when considering the purchase of a dental practice. The dentist, his/her accountant and lawyer can educate themselves doing due diligence before signing a letter of intent. While the buyer can continue to conduct due diligence until closing, the initial step should not be "glossed over."

In reality, however, the lawyer is frequently not brought in until after the deal is made and the buyer and seller have either shaken hands or signed a letter of intent (prepared, in many cases, by the broker). Sometimes, the seller or broker pressures the buyer to sign the letter of intent immediately to take the practice off the market. Too often, the lawyer is not given the opportunity to be involved in the "initial exam" of the target practice to be purchased. Instead, lawyers are engaged simply to "do the paperwork" and capture the economics of the purchase in writing. At this stage, it can be difficult to convince the buyer to either walk away from the purchase or re-negotiate the terms of the purchase.

There are many questions to ask and factors to examine before agreeing upon a price and signing a letter of intent to purchase a practice. At a minimum, the items listed below should be reviewed by a professional who understands the economics and practicalities of a dental practice acquisition. It is not enough to review a summary of a valuation report or rely upon the broker's opinion. The potential buyer should ask to see:

- Recent profit and loss statements, balance sheets, and income tax returns (at least three years).
- Percentage of collections used to cover overhead.Equipment valuation; typically, this should be performed by an independent dealer. The present value of all usable clinical supplies and hand instruments should be assessed, as well. In addition, does the practice own or lease the equipment?
- A detailed physical description of the office, including, by way of example, the number of operatories. Does the selling dentist own the underlying real estate?
- A production and collections report and a breakdown by each dentist and hygienist.An accounts receivable and aging report. In addition, what percentage of the accounts receivable is actually collected? Further, compare the aging report to the production/collection reports to verify that these reports are consistent and accurate.
- A description of any contractual relationships of the patients, employers or, insurance companies including HMOs, PPOs, DMOs, and capitation plans.
- A breakdown of practice expenses for insurance, retirement benefits, employee benefits, payroll taxes, medical reimbursement, telephone expenses, and continuing education. How much does it cost to run the practice?
- Total number of active patients and the number of new patients per month. This number will help the dentist and his/her advisors estimate an expected amount of cash flow for the practice. If the target practice is a specialty practice, a list of referring dentists would be extremely helpful. Where do new patients come from?
- How much revenue is based upon insurance reimbursements?

Aside from the financial items listed above, there are numerous issues that should be addressed by a lawyer who has dental industry experience and understands the legal aspects of a dental transition. Here are some examples:

1. What is being purchased?

First and foremost, is the buyer purchasing the goodwill of the practice (including the patient base) or simply the physical plant? These are two very different transactions. If the goodwill is being purchased, there are many additional factors to consider. For example, how will the selling dentist transfer the goodwill to the buyer? Aside from letters of introduction to patients and referrers, it can be helpful for the selling dentist to stay on for several months to make warm introductions to patients, families of patients, and referrers, and facilitate a smooth transition. Of course, the seller should not stay too long. After the seller leaves, what are the terms of his/her noncompetition and nonsolicitation agreement? These restrictions must be broad enough to ensure that the goodwill will be captured by the buyer,, but not overly broad which could cause these restrictions to be unenforceable.

Will the buyer purchase the receivables, as well? Address this issue early. If receivables are not included, the parties may agree upon how they will be collected for the seller. Buyers frequently charge an "administrative fee" for collecting the seller's receivables. If the receivables are purchased, some type of discount should be provided. The cash flow provided by the receivables can be extremely helpful.

If patients pay based upon a treatment plan (e.g., orthodontic contracts), will there be an adjustment to the price based upon services that have been prepaid?

Another crucial aspect is whether the seller is selling stock in the entity owning the practice (either a professional corporation or association, a partnership, or a limited liability company) or the assets of the practice. This factor is extremely important from a tax planning and risk management standpoint. While not within the scope of this article, sellers try to sell stock, and buyers prefer to purchase assets. In most cases, buyers win this argument.

2. Location, location, location

A significant part of the value of the practice, of course, arises from its location. As a result, it is absolutely critical to understand the basic terms of the lease. What is the duration of the lease? Are there options to renew the lease? What are the renewal terms? Does the tenant have a right to purchase the real estate?

Carefully review the lease to understand the actual per-square foot cost in addition to the base rent, as the buyer will probably be required to pay a portion of the taxes and other expenses and, with a condominium, a portion of the CAM fees (common area maintenance fees).

Alternatively, if the office is owned by the seller, it can be advantageous to negotiate a right to purchase the property, either immediately or at a later date. At the least, many buyers/tenants negotiate a first right of refusal, where the buyer has the first right to purchase the property before it is sold to a third party.

Buyers should look at the demographics of the location of the office. Is it growing? What will the area look like in 20 years? What is the rate of unemployment? What are the housing costs? Are there other dentists in the area? What is the dentist-to-population ratio? The local Chamber of Commerce may be helpful in this regard.

3. Restrictive covenants

It is important to determine whether the seller of the practice is the beneficiary of a no-competition or nonsolicitation agreement, which prohibits a former employee, partner, or owner of the practice from competing with the practice. If so, those documents should be reviewed to assess whether the buyer of the practice can enforce those restrictions. After all, part of the "goodwill" value of the practice may be dependent upon a former partner or employee not establishing a competing practice in the vicinity.

4. Liabilities; contracts

Although the accountant conducting his/her due diligence should see all liabilities upon reviewing the balance sheet, it is still important to order a lien search. While the buyer usually expects to purchase the equipment free and clear of encumbrances, a lien search will uncover whether a lender or leasing company has a lien on any of the assets. Although the buyer's lender will usually order a lien search, often the results of the search are not made available until days before the expected closing date, which can delay or derail a closing. The buyer can facilitate a smooth and timely closing by coordinating the ordering of the lien report with his or her lender.

5. Tax consequences

Before the letter of intent is signed, both parties should work with their tax advisor to understand the tax consequences of the transaction. How much tax will the seller be required to pay as a result of the sale? If this is a "deal killer," it is very helpful to deal with (and attempt to resolve) this issue early, not at the closing table (which occurs all too often).

Likewise, the parties should ask their accountants to think about the purchase price allocation sooner rather than later. While sellers typically desire to allocate a significant amount of the price to goodwill (in order to benefit from capital gains treatment), buyers prefer to allocate the price to certain other assets, as buyers must wait 15 years to reap the full benefit of the tax deduction arising from the cost attributed to goodwill. Again, don't wait until the day before closing to focus on this critical issue. Too often, this issue is not addressed at the right time.

6. Final thoughts

Buying a dental practice can be one of the most important milestones in a dentist's career. Aside from the issues discussed above, there are other matters to consider before signing a letter of intent in order to decide whether and how to purchase a practice, which may help the buyer to purchase the practice in an efficient and cost-effective manner. If additional due diligence dissuades the dentist from purchasing the practice, it is better to make that decision as early as practical. Although the letter of intent is nonbinding, after it is signed, the parties become entrenched in their positions and any attempt to change the terms may be viewed as a "breach of good faith." Working with a trusted advisor who understands the business and challenges of an acquisition can ensure that the dentist makes a thoughtful and thorough initial exam.

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