

BUSINESS AND TAX ASPECTS OF PROFESSIONAL PRACTICE ACQUISITIONS

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I. INTRODUCTION

The purchase of a healthcare practice, whether it is medical, dental, orthodontic, or even veterinary, is different than other types of business acquisitions. While many of the concerns are the same, health care practices have their own unique characteristics and considerations that the purchasing doctor and his/her advisers must take into account. The differences start early — a professional and his/her advisors must know how to prepare the practice for sale so it is presented in the most favorable light for evaluation and for potential financing. They continue all the way through closing, when seemingly commonplace issues like closing adjustments, accounts receivable, and assumption of liabilities may not be handled as they would be in a non-healthcare business transaction.

There are also special considerations if a new doctor will be employed for a time prior to the sale, or become a partner or shareholder for a time prior to completing the acquisition. In these situations, special attention must be paid to health care specific issues such as the permissible scope of non-compete, industry standards relating to work schedules, and doctor expectations for the partnership.

Healthcare professionals are aware that their businesses require special expertise from their advisors. Therefore, they will expect business, tax, and legal advice to be delivered with a high level of healthcare expertise.

II. ASSEMBLE A TEAM

When a doctor prepares to acquire a practice, he/she should assemble a team of advisors suited to deal with the unique aspects of the healthcare world. There are three basic types of advisors that any acquiring professional should consider retaining.

1. A practice valuation expert. There are quite a few consultants and valuation experts practicing exclusively in the healthcare field. Some of these consultants may also function as brokers. Although brokers serve an important function, we generally find that a valuation expert or a practice acquisition consultant who is compensated on a flat fee rather than commission basis may provide a more nuanced and unbiased approach.

A choice of a consultant should be driven by quality referrals from lawyers, CPAs, or other doctors who have had good experiences with the consultant. The doctor should be able to

feel confident that the consultant has significant experience in valuing practices within the specialty of the target practice.

2. Legal counsel. Too many doctors rely on a family member who is an attorney, an old college acquaintance, or "the guy who got me out of my last ticket", to provide legal counsel. However, these persons may not be versed in the intricacies of healthcare practice, especially in acquisitions. They may also not be aware of the significant tax ramifications inherent in any acquisition, nor may they be experienced in various regulatory issues associated with healthcare practices. Therefore, a doctor who is either buying or selling a practice should seek out a qualified attorney with experience in the healthcare field.

Generally speaking, an attorney with significant experience in handling medical practices will be able to handle an acquisition of most types of subspecialties. Unlike valuation issues, legal issues are generally not as likely to vary significantly among specialty practices. The same goes for dental, orthodontic, and even veterinary practices. There are significant differences between dental and orthodontic practices, however.

3. CPA. Because of some of the unique accounting and cash flow issues associated with healthcare practices, practitioners should chose a CPA who is experienced in dealing with professional practices. A qualified CPA counseling an acquiring healthcare professional should have the ability to project practice cash flow to make sure that it will be able to support the carrying cost of debt incurred for the purchase. This also will serve as a useful "sanity check" on the calculations of the valuation expert. If projected cash flow is not sufficient to cover the financing for the asking price, and leave a reasonable income for the doctor(s), it is a good sign that the asking price may well be too high. Qualified CPAs can also add value by spotting irregularities in the target practice's books and tax returns, including transactions with related parties that may not be on market terms.

III. ANALYZE FUNDAMENTALS

Buyers of healthcare practices, including new partners, must analyze the fundamentals of the practice they want to acquire or enter. Of course, the team the practitioner has assembled remains instrumental in this process, especially the valuation expert and CPA. It is not the purpose of this paper to describe how to value a healthcare practice, but it is important to point out that there are certain financial fundamentals that buyers should examine. Naturally, it is also in the best interest of a seller to pay attention to these fundamentals before putting the practice on the market.

Of course, as in the valuation of almost any business, cash flow is the key. In analyzing cash flow, valuation experts may use different methodologies, but the basic idea is to determine net income after all expenses, and then increase net income by adding back in all the expenses associated with owner compensation and benefits. This will reveal the true amount of income available to a buyer.

Healthcare practice valuation does differ from valuation of many closely held businesses in one important way, which is that the valuation expert often must take into account the value of

the salary that the acquiring physician, dentist, or orthodontist could make if he or she did not buy the practice. This valuation element is generally not present in appraisals of non-professional businesses. For example, if a manufacturing business has gross income of \$1,000,000, and after expenses \$500,000 are available to provide an income to the owner, the valuation expert would generally divide that \$500,000 net income by a capitalization rate to determine the value of the business. If the valuation expert determined that the appropriate capitalization rate was 20%, \$500,000 would be divided by 20% to arrive at a value of \$2,500,000.

In the healthcare world, however, by buying a practice a qualified physician, dentist, or orthodontist is often giving up a very substantial salary and benefits package. Furthermore, the gross income of the practice is being generated in very substantial part by the personal efforts of the professional who owns the practice. The amount of the foregone compensation can be estimated by applying industry norms, adjusted for geography and specialty. Therefore, using the same numbers as in the example above, a valuation expert might discount the \$500,000 net income by subtracting all or part of the normal compensation package that the physician, dentist, or orthodontist could earn working in a comparable practice. Perhaps the physician could earn \$250,000 in compensation at a comparable practice. This means that the difference between those two numbers, \$250,000, is then divided by the capitalization rate, which we will again presume is 20%, to reach an estimated practice value of \$1,250,000. This is the effective value of owning the practice, over and above simply working there. Generally, the fair market value of the tangible assets of the practice will be added to this estimate to arrive at a purchase price.

In some types of healthcare practices, in addition to adding tangible assets, certain types of intangible assets might be added as well. A primary example is the value of "contracts receivable" in the orthodontic profession. Contracts receivable are existing contracts to provide orthodontic care to patients in the future. They represent a reasonably certain stream of future income to the practice, and therefore are factored into the practice value, perhaps with a reasonable present value discount applied. There may be other types of intangible assets, such as a valuable trade name or trademark that is recognized in the community; however, in most cases these types of intangibles are accounted for in the calculation of the value of the practice based on its cash flow as outlined above.

The foregoing is far from an exhaustive summary of valuation methodologies for healthcare practices. Every valuation expert has unique preferences and techniques. In particular, the process of determining the correct capitalization rate to apply to a practice's net income is more art than science. However, the general overview described above may help both buyers and sellers.

In addition to examining cash flow, buyers and sellers must take a critical look at the quality of the assets they are purchasing. Even if a practice's cash flow is good, a buyer should think carefully before purchasing a practice that will quickly require large capital expenditures to replace obsolescent equipment or perform deferred maintenance. In the healthcare industry especially, equipment is very expensive and in some cases, may become obsolete very quickly.

There is a flip side to this consideration, however. Some practices in certain specialties may have good cash flow that could be increased through the purchase of additional equipment that serves as a profit center. In the past few years, physicians and dentists have invested in increasingly expensive imaging and laboratory technology so they can provide in-office x-rays, CT-scans, MRIs, and pathology services, using the expensive equipment to generate additional profits (although some of these arrangements are under attack through the new "Anti-Markup" regulations). Therefore, a buyer may look at a potential acquisition target and see that the target's already good cash flow can be leveraged to add valuable equipment that will generate even more cash flow in the mid- and long-term. If this is not the case, however, a buyer must understand how the practice's short- and mid-term cash flow will likely be affected by the cost of replacing outdated or obsolete furniture, fixtures, and equipment, and discount the purchase price accordingly.

Sellers must also look critically and honestly at their physical plant before offering a healthcare practice for sale. Even if the practice's cash flow numbers are good, a savvy buyer may demand discounts if the assets are obsolete. Therefore, sellers should consider strategically replacing key assets a few years before offering the practice for sale. Sellers should not seek to maximize cash flow by deferring maintenance and replacement of assets. Besides potentially driving patients away to more modern practices, this may lead to discounts when the time for a purchase comes. The discounts and loss of patients may well be more substantial than the amount the seller would otherwise have spent in performing ordinary maintenance and needed replacements.

Other than spending to keep the physical assets of the practice in good shape, however, a doctor intending to sell should concentrate on cash flow and look to eliminate inefficiencies and unnecessary expenses in the practice in the three to five years leading up to a plan sale. This will enable the seller to present the best picture to the buyer's valuation expert. Sellers should take a hard look at their coding and billing practices, and try to take management steps to maximize reimbursement rates. Non-productive personnel should be eliminated or replaced. Also, the seller should look carefully at extra "perks" and business expenses that are really primarily benefits to the owner, and either eliminate these items or clearly show them on the financial statements as additional owner compensation. This may produce a tax disadvantage from foregoing deductions in the short term, but may result in a higher purchase price in the long term. Seller should work with their tax and business advisors to implement these steps in a way that balances the financial and tax risks and rewards.

In many healthcare practices, sellers can also amplify cash flow by working harder — in orthodontics, this translates to more new patient "starts", and in dental and most medical practices, this translates into more patients seen or procedures completed. This idea may not be palatable to doctors who are seeking to wind down their practices. For this reason, sellers are always better off selling while they are still energetic enough to maximize the value of their practices. If a seller waits until he or she is exhausted and desperate to retire, the seller will find that the value of the practice has declined from its peak.

IV. BE PICKY

As in any business acquisition, a professional practice buyer should look carefully at all the options. A practiced consultant may be able to assist the doctor in locating a practice that will be a good fit both economically and geographically. Even after finding an attractive practice, the buyer should consider getting a "second opinion", which may come from his CPA and legal team.

In many cases, the seller of a healthcare practice will continue to be employed, either on a full-time or part-time basis, after the closing. If this is the case, the buyer must carefully consider whether there is a fit of personalities and priorities. This is even more important when the buyer will be entering into a long association (or even partnership) period prior to acquiring control of the target practice.

Of course, the same considerations also operate for a seller. Although issues of compatible personalities may not be so important in the case of a complete sale of the practice, they are very important if the seller intends to bring in the purchaser as an associate and/or a partner for a significant period of time prior to closing the sale. In many cases, even if a sale is contemplated by both parties from the beginning, there may be a lengthy association period during which one or both parties has the right to exit the relationship without further obligations (except, of course, covenants not to compete and, in some cases, loss of earnest money) if the relationship does not work out.

We strongly advise sellers bringing in new associates to run background checks prior to entering into any binding agreements. Failure to investigate the background of new doctors entering a practice could potentially give rise to liability for the practice.

Different types of healthcare practices have different trajectories for the entry of new doctors into the profession. For example, in orthodontics, it is very common for new orthodontists to immediately enter into partnership agreements when they leave school. These partnership agreements frequently will install the new doctor as an equity owner of the practice, with an obligation to purchase the existing doctor's remaining equity interest after a set period of years. These arrangements may begin with a year to two year association period, during which the personality compatibility of the doctors will be tested before partnership begins. However, it is very common in orthodontic transactions for the partnership agreement and eventual buy out to be agreed in writing at the very beginning of the relationship.

The same trajectory may also be followed in dental practices, but it is also not at all uncommon for a new dentist to purchase a practice from a retiring doctor upon graduation from dental school. Dental practices are currently enjoying excellent profit margins and returns across the industry, and there are many lenders eager to provide financing at a very high loan to value ratio for new dentists.

Medical practices may offer trajectories similar to those seen in dental and orthodontic practices or they may involve long periods of employment before partnership is achieved. The structure and timing varies widely across the medical industry, and is highly dependent upon

particular specialty and geographic area. As hospitals acquire practice groups, and as groups in urban areas grow larger and more corporate, doctors in many specialties may never have the opportunity to desire to become owners.

In veterinary practices, new vets are commonly employees for many years before becoming equity owners. Some may remain employees throughout their careers.

V. TARGET ACQUIRED

Once a buyer and a seller have met and decided to move forward with a transaction, it is time for the doctors' respective advisors to start working to move the transaction forward. It is not at all uncommon for transactions involving healthcare practices, especially acquisition transactions or transactions in which a new doctor is buying into an established practice, to take significantly longer than "normal" non-healthcare acquisitions. This is because in most cases the doctors involved will be going through the process for the first time. They will have no experience at all in acquisitions, except that the selling doctor may have some recollection of when he/she originally purchased the practice years ago. The seller may have unrealistic expectations that will need to be sorted out during the negotiation process. Similarly, the buyer may have unrealistic expectations that the transaction will go quickly.

1. The Letter of Intent. Many attorneys have a bias against letters of intent ("LOIs"). We often advise our clients that a LOI is a waste of time, because we could just as easily move directly to definitive documents (the asset purchase agreement, the partnership agreement, employment agreements, and so forth) without "wasting the time" to prepare an LOI. After five years of working on professional practice acquisitions, I believe that this approach is completely incorrect in most healthcare practice acquisitions. I am convinced that a well thought out and fairly comprehensive letter of intent, is a very valuable component of the acquisition of the healthcare practice, and should be used in almost every circumstance. The LOI may be partially or wholly binding in certain circumstances, and require the deposit of earnest money by the buyer. There are several reasons for my conversion to a believer in LOIs.

First of all, as mentioned above, in most healthcare practice acquisitions, both parties will be doing this for the first (and possibly the last) time. The clients on both sides of the transaction are not generally experienced business persons who have bought and sold several businesses and assets and are well versed in the intricacies of legal documentation — they are doctors.

Second, as also mentioned above, acquisitions of healthcare practices often stretch out over a very long period of time. The negotiations are often lengthy, often starting before a new doctor even graduates from school. In many cases, the signing of the actual purchase documents may be delayed until after a new doctor has been employed by the existing practice for months or years. The LOI is invaluable during this long delay. It helps the doctors remember what they discussed and agreed upon in the beginning of their relationship.

Third, if the LOI includes a provision requiring the buyer to make a deposit of earnest money that may be forfeited if the buyer does not proceed with the transaction, or if the buyer violates confidentiality and non-compete covenants, the LOI will provide a very important

protection for the value of the seller's practice. Otherwise, the buyer may be able to obtain valuable information about the seller's practice during the due diligence period, and use that information against the seller by breaking off the deal and setting up practice independently in a competing area. This is especially important in situations where a new doctor has the ability to "hang out a shingle" in the seller's town, such as in the orthodontic, dental, veterinary, and many medical fields.

Forth, and most importantly, the process of negotiating a letter of intent tends to flush out any serious areas of disagreements between the doctors. The seller may want to immediately retire after the closing and travel to Antigua — permanently. The buyer, on the other hand, may be expecting a significant period of consulting and part-time employment by the seller to enable the buyer to fully take advantage of the goodwill he/she is buying (of course, the opposite may also be true — the new doctor may want the old doctor out as quickly as possible). There may be serious issues of allocation of the purchase price. The new doctor may demand the ability to purchase the real estate where the practice is located, but the old doctor may have no intention of selling the asset. It is better to discover these issues early in the process, rather than have a meltdown in negotiations later on, perhaps after the buyer has already begun to work in the seller's practice.

All in all, the LOI serves a very important psychological purpose in healthcare practice acquisition. I strongly recommend the use of an LOI in almost every circumstance.

2. Due Diligence. After a LOI is in place, the buyer will want to conduct due diligence on the practice. Generally, the buyer's attorney will take the lead in this process.

Due diligence in the acquisition of a healthcare practice has most of the same elements as in acquisitions of other types of businesses. For example, the buyer's counsel will conduct searches of the public records to determine if there are any liens in favor of lenders or government authorities that must be satisfied so that the buyer can take good title to the assets. In most states, buyer's counsel should consider obtaining a tax clearance letter from the Department of Revenue. If the practice has any contracts or leases that are critical to its ongoing operation or profitability, the buyer's counsel must review these contracts to determine whether or not the change in ownership of the practice assets will cause an event of default under the contract, or give the other party the right to terminate the agreement. These contracts could include common contracts, like copier leases, or healthcare-specific, such as a contract to provide medical or dental services to residents of nursing homes or other healthcare facilities. If these contracts are an important source of revenue that the buyer wants to maintain, the buyer will need to make sure that there will be no difficulty in assuming the contract from the seller.

In addition, in the acquisition of a healthcare practice the buyer should consider reviewing the seller's disciplinary records with state licensing authorities, if those are public information in the state in questions. A recent series of infractions may indicate that the goodwill of the business has been damaged. If these types of records are not public knowledge in the state where the practice is located, the buyer may request that the seller voluntarily disclose any disciplinary actions within the past three to five years.

If important assets of the practice are leased, which may be the case with expensive medical equipment and ordinary office equipment such as copiers, the buyer should determine whether or not he/she will be assuming liability for the lease and make sure that the written lease agreement allows the buyer to assume the contract from the seller. Some medical equipment can be subject to long-term maintenance contracts, which may or may not be beneficial. The terms of these contracts should be carefully examined.

3. Employment Agreement. Frequently, there is a period of employment by the new doctor before a formal purchase agreement is entered or becomes binding. In many acquisitions, the seller and his/her advisers may insist that the purchaser should enter into a complete set of purchase documents before becoming employed by the practice. Although the buyer may resist this, the advantages to the seller are significant. The seller has the comfort of knowing that the time and effort spent training the new doctor will not be wasted, and will be able to focus on transitioning the practice and not looking for a new buyer. The buyer will be able to use these signed purchase contracts to secure financing. The signed documents must include a well-drafted employment agreement.

However, if the buyer and seller do not wish to enter into a firm purchase agreement before beginning a period of association, then it is even more important that the buyer be bound by a well-crafted employment agreement, which should include noncompetition and confidentiality covenants to the extent permitted by applicable state law, and to the extent required to protect the selling doctor's interests and the value of the practice.

The employment agreement should also outline other important elements of the relationship. Most doctors and healthcare professionals will require their agreements to include very specific language regarding their work schedules. In most medical practices, this will include the discussion of the "call schedules" or other arrangements for covering after-hour patient emergencies. In dental and orthodontic practices, this will normally take the form of designated "clinic days" (i.e., days on which the doctor will be present at the practice facility and providing treatment to patients).

Of course, compensation will be a major factor in any employment agreement. A comprehensive discussion of physician compensation is beyond the scope of this paper. Rest assured, however, that consultants for newly minted doctors, orthodontists, and dentists will have a very clear idea of how much their clients should be paid.

If the seller will be employed after the purchase, or if the parties are entering into a partnership arrangement where both will be providing services to the practice, the seller must also enter into a employment agreement that must be negotiated with the buyer. Most of the same considerations are present in the seller's employment agreement as in the buyer's. In an acquisition, the buyer may well be expecting the seller to provide transition and consulting services after the sale. If so, these expectations should be laid out explicitly in the post-sale employment agreement. If the seller still wants or needs to work significant hours to supplement his or her income and retain access to employer-based health insurance, the seller may negotiate for a guaranteed salary, or if compensated on a per diem basis, a guaranteed number of clinic days for a set term of years.

It is critical that every employment agreement contain clear provisions outlining how the arrangement may be terminated. In the case of an association period leading to an acquisition, the buyer will likely demand that the employment agreement be terminated only for cause. If the seller will not agree to this, then the buyer will request that any earnest money paid upon the commencement of the association be returned if the buyer is fired without cause, and that in the event of any termination the buyer be released from his or her obligation to purchase the practice. These are reasonable requests that should generally be accommodated by the seller. Sellers will generally want to retain the ability to fire the associate without cause, and buyers may want to retain the ability to walk away without cause. This enables each party to recognize that the relationship is not working and to go their separate ways before an acquisition is consummated. Sellers of healthcare practices may want to demand earnest money from buyers that will be forfeited if the buyer leaves during the association period without cause.

Of course, this focus on whether termination is "with cause" or "without cause" will bring up a very important topic — what exactly is "cause"? Clearly, the employing party (the seller with respect to pre-acquisition association, the buyer with respect to post-acquisition employment of the seller) will want the term "cause" to be as broad as possible. The employer will want "cause" to be defined to include insubordination, failing to follow the practice's policies and procedures, failure to observe proper patient care practices (even practices that are in excess of the minimum required by professional standards). These types of "soft" justifications for termination will be in addition to other, "hard" justifications, such as the loss of necessary licensure or privileges, loss of ability to prescribe narcotics, conviction of felonies or misdemeanors involving morale turpitude, embezzlement, or violations of the employment agreement. The employee, of course, whether it is the buyer during an association period or a seller during a post-sale employment arrangement, would like to see termination "for cause" limited to only these "hard" justifications.

3. Structuring the Acquisition. The buying and selling doctors will need to make several decisions, preferably during the LOI process, about the structure of the transaction. There are several important issues to consider: (i) will the acquisition occur all at once, or will there be a partial buy-in and partnership period followed by a complete buy-out?; (ii) will the purchase price be paid at closing, or over time (*i.e.*, will the seller provide financing for the buyer?); (iii) how will the purchase price be allocated?; (iv) if the seller owns the real estate upon which the practice is located, or will the real estate be included in the deal?; and (v) if the buyer isn't acquiring the real estate, what are the terms of the lease?

(i) Partial or Complete Purchase?

By far the most important question in any healthcare practice acquisition is whether the acquisition will be completed all at once, or whether the buyer will be a partner with the seller for some period of time — perhaps an extended period — prior to completing the purchase. An "all at once" purchase is a relatively straightforward transaction. The primary issues are those discussed elsewhere in this paper, such as employment for the seller after closing, terms of seller financing, if any, issues of allocation of purchase price, and others. If, on the other hand, buyer and seller will be partners in the practice for some period of time before the buyer takes over full ownership, a whole host of other issues are raised.

Sellers need to decide early on in the process of selling their practice whether or not they are willing to accept a partnership leading to a sale. If seller is nearing the end of his or her career in any case, it may not be practical or desirable for the seller to work with a partner for a significant time period.

Also, buyers need to understand what they are looking for in a new practice. If the buyer is confident that he or she will be able to step into an existing practice and operate it successfully with little or no hands on training from a more experienced doctor, the buyer may not want to take on the additional burdens of operating a partnership. On the other hand, many specific specialties and fields almost require a certain amount of on-the-job training, and therefore lend themselves naturally to a period of partnership. In any case, both potential buyers and potential sellers need to carefully consider this issue before they begin the acquisition process.

(ii) Will There Be Seller Financing?

Assuming that there will be a complete sale of the healthcare practice without an ongoing partnership, the parties need to determine whether the seller will finance the purchase. Of course, sellers will always prefer to receive all their money at closing, without being required to finance any portion of the acquisition. In some cases, where the buyer is entering a partnership with the seller, such that the seller is splitting part of the practice's income with the buyer and also providing seller financing, the seller may well perceive that he is essentially paying for his own practice sale.

Certain practices and specialties are commonly eligible for nearly 100% loan to value ratio loans, even in the current difficult lending environment. For example, successful dental practices are very easy to finance. If the seller cannot find a buyer able to borrow or personally fund the entire purchase price, the seller will likely be required to finance some portion of the purchase. The buyer must work with his or her advisory team, especially a CPA, to determine whether or not the overall debt burden can be supported by the practice, based on conservative income and expense projections.

The terms of the financing and the collateral will vary greatly depending on the circumstances. Generally, seller financing will be subordinated to bank debt. The seller should consider taking a security interest in the assets of the practice.

If real estate is involved in the sale, then the seller should definitely consider taking a second mortgage, subordinated to the mortgage of the primary lender, to secure his or her position as a lender. If no real estate is involved, then the seller's security options are less attractive. A subordinated position in the practice's furniture, fixtures and equipment may have little practical value. Therefore, the seller should negotiate for a provision in the loan documents that will release the seller from his or her non-compete obligations if the buyer defaults on the seller's note. This may enable the seller to re-enter the practice and essentially repossess the practice's most valuable assets, the patient and referral base. The same is true in reverse, of course, and the buyer may well insist on a reciprocal provision in the note that allows the buyer

to cease payments on the seller's promissory note if the seller breaches his or her non-compete obligations.

In some cases, especially if the target practice is underperforming for some reason, the buyer may want to consider structuring the seller's note as an earn-out. In other words, there will be a minimum amount owed under the note, and the total amount paid may increase if certain income or other economic performance thresholds are met during the course of the loan. If this is the case, sellers will want to carefully negotiate the earn-out provisions. For example, a net income escalator may be objectionable because it is easily manipulated by the buyer, and may be difficult to verify. In orthodontics, a reasonable metric for an earn-out escalator would be new patient starts. With certain medical specialties, number of procedures might be a workable metric. However, gross income is generally a more reliable marker than any other metric.

Both buyers and sellers should carefully consider prevailing Medicare and Medicaid reimbursement rates, and any predictable upcoming changes in policies of important governmental and private insurers. For example, if the seller anticipates that payment rates and policies in his or her specific specialty or field are likely to become less favorable to doctors during the earn-out term, the seller should try to avoid an earn-out in the first place, or if that is not possible, negotiate for earn-out markers that are not dependent upon payment rates, such as patients seen or procedure counts.

(iii) How Will the Purchase Price Be Allocated?

Sellers and buyers also frequently run into conflict over the allocation of the purchase price among the assets acquired. Because of the tax consequences involved, buyers always prefer to allocate as much of the purchase price as possible to the practice's furniture, fixtures, and equipment. These assets can generally be very quickly depreciated or even expensed post-closing. Sellers, on the other hand, want to minimize the allocation to furniture, fixtures and equipment, because all amounts allocated to these items will generally be taxed to the seller at ordinary income rates due to depreciation recapture.

Sellers prefer to allocate the purchase price to goodwill. Amounts allocated to goodwill of the practice (in S corps, or LLCs taxed as partnerships), or to the seller's personal goodwill, are taxed to the seller as capital gain, but the buyer will be required to amortize these amounts over 15 years instead of quickly depreciating them. This is a matter of negotiation in nearly every practice acquisition.

In some ways, it is easier for the buyer to concede in the allocation issue, because to the buyer the difference is simply one of timing. To the seller, the difference is perhaps more significant and immediate, because the allocation will directly affect how much of the purchase price the seller gets to keep, and how much the seller must turn over to the federal and state governments in the form of taxes. Therefore, buyers may be able to trade a seller-favorable allocation of purchase price for some other concession that is more important to the buyer, such as favorable seller financing terms.

Another issue that frequently comes up in discussions over purchase price allocation is whether amounts allocated to goodwill should be allocated to corporate goodwill or to the selling doctor's personal goodwill. This issue is most commonly encountered when the seller is selling the assets of a practice owned by a C corporation. Goodwill sold by a C corporation is subject to tax at the corporate rate, not at favorable capital gains rates. If the selling doctor is able to characterize the transaction as a sale of his or her personal goodwill, the seller will be able to use a favorable capital gains rate by keeping the income out of the C corporation. The question in this situation is whether or not the selling doctor can legitimately characterize goodwill being sold as the seller's own personal goodwill. Practitioners will need to look carefully and critically at the practice and applicable law to determine whether they can make a successful argument to the IRS that the goodwill in question belong to the doctor personally, and not to the corporation.

In order to provide maximum support to the allocation of part of the purchase price to personal goodwill, a selling doctor's attorneys and CPAs should consider taking some or all of the following steps:

(a) There should be a clear written agreement between the selling doctor, individually, and the buyer describing the transition of goodwill. The written agreement should require the selling doctor to provide introductions and transition assistance, to provide training or other assistance to the incoming doctor and to provide letters or other appropriate announcements to the patients and referral sources of the practice regarding the transition.

(b) If appropriate, the selling doctor should continue to work with the buyer after the closing, either as an employee or an independent contractor, to introduce and transition patients and referral sources.

(c) The purchased documents, whether the asset purchase agreement or separate transition services agreement, should clearly describe the nature of the personal goodwill that is being transferred, describe how it differs from the corporation's own goodwill, and recites specific facts illustrating how the selling doctor has created and increased his/her own personal goodwill during the time he/she has owned the practice.

(d) In advising sellers, attorneys and CPAs should be very careful to investigate whether or not the seller already has a non-competition agreement with his or her practice. These can be left over from prior partnership agreements or hidden in stockholder buy-sell agreements. If a selling doctor has a non-competition agreement with his or her professional corporation, then effectively the corporation owns all of the selling doctor's personal goodwill by operation of the contract.

(e) The allocation of goodwill to a seller must be supported by a noncompetition agreement between the selling doctor and the buyer.

(iv) Will Real Estate Be Included?

If the selling doctor owns the real estate upon which the practice facility is located, the buyer and the seller will need to discuss whether or not this real estate is included in the sale. Many doctors have a strong desire to acquire the real estate and enjoy the significant business, financial, and tax advantages associated with owner occupied real property. However, in some cases, the seller will consider the real estate to be a significant long term investment, and the seller may be counting on continued income from the real property to support the seller in his/her retirement years. Seller may even desire to leave the real estate to his/her family. This is especially the case if the practice facility is located in a larger medical office complex or shopping center environment, where the selling doctor owns the surrounding real property and enjoys rental payments from tenants other than his own practice. If this is the case, the buyer will have to decide whether or not controlling the practice real estate is critical to the deal.

On the other hand, if the real estate does not seem to be an attractive investment to the buyer (*i.e.*, the facility is rundown, too small or too large, located in an undesirable neighborhood, or in a larger complex that is not well-managed), the buyer may refuse to buy the real estate even if the seller wants to sell. This can also lead to a conflict between the buyer and the seller, if the seller is counting on being able to liquidate the real estate as part of the sale. In some cases, the value of the practice may not be sufficient to allow the seller to retire, and therefore, it will be very important to the seller to find a buyer who is willing to purchase the associated real property.

If real estate is to be purchased, there will be significant additional due diligence required. The buyer can expect to expend additional sums on surveys, title searches, environmental reports, and other real-estate related due diligence. The buyer should choose legal counsel that is experienced in the acquisition of commercial real estate.

(v) What are the Terms of a Real Estate Lease?

If the practice facility real estate will not be sold to the buyer as part of the acquisition of the practice, the buyer must carefully review the lease documentation. If the real estate is owned by a third party landlord instead of the selling doctor, the buyer must ascertain that the lease can be transferred to the buyer, or if not, must obtain the landlord's permission to assume the lease. The buyer must also carefully review the terms of the lease to make sure that none of them are seriously objectionable. Again, the buyer's attorney will be critical in this process, and buyer should chose counsel experienced in the review and negotiation of commercial real estate leases.

It is very important to take into account the term of the practice facility lease, as well. If the practice is located in a very attractive facility, but the lease will expire in a few months or years, the buyer should consider placing a closing condition in the asset purchase agreement that releases the buyer from the obligation to purchase if a lease extension cannot be negotiated on reasonable terms. On the other hand, if the practice facility is not attractive, and the buyer believes that he/she can improve the performance of the practice by moving to a better location, the buyer might consider pursuing a reduction in the lease term with the landlord, with a corresponding closing condition in the asset purchase agreement.

Generally speaking, the process of dealing with the lease is much easier if the selling doctor owns the practice facility. If the buyer will not be acquiring the real estate, the terms of the lease of the facility should be discussed during the Letter of Intent stage. Points of discussion should include the term of the lease, the monthly rent and any escalation clauses, the buyer's ability to move out and sublease the premises, the landlord's rights in the event of default, and so forth.

If the buyer will be leasing the practice facility from the seller, it is very common for the buyer to negotiate for a right of first refusal or an option to purchase the practice facility. The details of these documents will vary based on the local real estate market and the seller's future plans to sell the facility, and should be discussed and documented in the LOI.

5. Asset Purchase Agreement. After the buying and selling doctors have reached an agreement on the essential terms of the purchase, generally in the form of a carefully negotiated LOI, counsel for the parties will begin work on the purchase documentation. Generally, this will take the form of an asset purchase agreement. Stock purchases are very rare in the healthcare field, due to the overriding concern over the liability for past incidents of malpractice that have yet to be disclosed. Asset purchasers are the norm, except in cases of new partners buying into large and established practice groups.

If all goes well during the letter of intent stage, most of the contentious issues will have been decided before drafting of the asset purchase agreement ever takes place. For example, allocation of purchase price, the role of the seller post-closing, and the structure and terms of seller financing, if any, all should be settled by this point in the transaction. Therefore, all that should remain is placing these important terms into the framework of a formal asset purchase agreement.

Most asset purchase agreements contain six main types of provisions: (i) description of the assets being purchased; (ii) description of how the buyer will pay for the assets; (iii) representations and warranties; (iv) post-closing covenants (such as non-compete and seller employment); (v) conditions to closing; and (vi) indemnification provisions. All or most of these items should have been addressed in some form in the letter of intent, especially a description of the assets, arrangement for the purchase price (including seller financing and allocation), post-closing services of the seller, and sometimes conditions to closing. It is fairly common, however, for the letter of intent to be fairly vague on representations and warranties, indemnification provisions, and often conditions to closing.

(i) Representations and Warranties.

The representations and warranties found in a typical healthcare practice asset purchase agreement are not terribly different from those commonly seen in agreements regarding the purchase of other types of closely held businesses. The principal selling doctor will be expected to make the representations and warranties jointly and severally with the practice entity.

Sellers will be expected to represent and warrant that they have good title to the assets being transferred, have all necessary authority to transfer the assets, that no third party is

required to consent to the transfer, and that the transfer will not violate any other agreement to which the selling doctor or practice is a party. Also, sellers should expect to be asked to represent and warrant that all financial statements and records presented to the buyer are true and correct and prepared in accordance with reasonable accounting conventions (GAAP is not generally required), that the assets being transferred are in good condition and repair, that all taxes have been paid, that seller has maintained sufficient professional liability insurance throughout its ownership of the practice, that there is no on-going or threatened litigation, and that the statements made by the selling doctor and the company to the buyer have been materially true and correct. Depending on the transaction and the nature of the practice in questions, certain more specific representations and warranties may be requested. These may include specific representations regarding compliance with Medicare and Medicaid policies, Stark laws, hospital privilege policies, and other practice-specific issues.

In comparison to other types of acquisitions, it is relatively rare for significant negotiation or controversy to erupt over representations and warranties in the acquisition of a healthcare practice. If the physical assets of the practice are older and in need of replacement, sellers may resist giving a blanket warranty as to their condition, and instead may seek to make exceptions and disclose some of the defects in the assets. Any on-going litigation will need to be disclosed, as well. If there are other representations and warranties that raise issues upon examination by the seller's attorney, exceptions to these representations are generally disclosed in a separate, attached schedule. Hopefully, these items, if any, will be revealed during the due diligence process in any case.

(ii) Indemnities.

Indemnification language can sometimes cause controversy during the process of negotiating an asset purchase agreement. Generally speaking, buyers will seek very broad indemnification language, requiring the seller and the selling doctor personally to agree to indemnify the buyer against any and all liabilities arising from the seller's operation of the practice before the day of closing. This will, of course, include any malpractice claims arising from events prior to the date of closing.

In many cases, however, the buyer will be employed at the practice for some period of time prior to closing. During that time, it is possible that the buyer may have committed malpractice or other actions giving rise to liability, but neither the buyer nor the seller has yet been notified of the claim. Therefore, it is common for the seller's indemnification obligation to exclude any liability arising from actions of the buyer while employed by the practice prior to closing.

Similarly, most asset purchase agreements contain a buyer's indemnification provision requiring the buyer to indemnify the seller against any liabilities arising after the date of closing. Of course, sellers are often employed or contracted to provide services to the buyer's practice post-closing, and therefore there may be a risk that the selling doctor will commit malpractice or create some other liability after the closing. Therefore, it is common for the buyer to request an exception from the buyer's indemnification obligations so that the buyer is not responsible for any liability caused by the negligent acts of the seller post-closing.

Of course, each party will indemnify the other against any losses arising from breaches of representations or warranties, or from breaches of the agreement itself.

It is common in many types of business acquisitions for the seller to negotiate some type of cap on indemnification obligations. This is not terribly common in healthcare acquisitions because major liabilities are usually malpractice-related and will be covered by insurance. In any case, because the deal is structured as an asset acquisition, it is unlikely that a buyer will have any significant exposure to the seller's negligence actions that result in a malpractice suit. Incidents giving rise to seller's indemnification obligations outside of the malpractice arena would generally be fairly minor (for example defective equipment or undisclosed issues with employees or vendors). If seller does choose to try and negotiate for a cap on his/her indemnification obligation, there are no hard and fast guidelines regarding the amount of the cap or what relationship it should bear to the purchase price. It is not uncommon for non-malpractice related liabilities to be capped at the purchase price, and depending on the amount of the purchase price itself, the cap may be much lower (perhaps down to 25% of the purchase price).

(iii) Conditions to Closing.

A "condition to closing" means an event that must occur (or fail to occur) in order for the buyer and seller to have an obligation to close under the asset purchase agreement. Most closing conditions in healthcare practice acquisitions run in favor of the buyer; in other words, if a closing condition is not met, the buyer does not have to buy the practice, but has the option to waive the condition and continue on with the purchase. Seller's risks include exposing confidential information to the buyer, possible instability and dissatisfaction among the seller's employees if and when news of the transaction gets out, and possibly loss of patients if an upcoming transaction is announced but does not close. In some circumstances, the seller may also be relying on the closing of the transaction to pay other obligations, such as bank loans that are coming due.

The most commonly seen, and often most contentious, closing condition is a financing contingency. The buyer will request a release from the obligation to purchase the practice if the buyer cannot find financing that is acceptable to the buyer, in the buyer's sole discretion. Sellers will naturally object to this provision, as it gives the buyer an easy "out" to the contract, which can be exercised simply by the buyer's statement that he/she doesn't like the financing terms on offer. Sellers will generally argue that they are exposing their practices to significant risks by entering into the asset purchase agreement, and so the buyer should not have such an easy way to avoid the purchase.

A compromise on the financing contingency can be reached in several different ways. Sometimes, the seller will agree to provide seller financing if the buyer cannot obtain favorable third party loans. In other transactions, seller and buyer will agree on the general scope of a third party loan that will be acceptable to the buyer, including interest rate and term, and if the buyer is able to obtain a loan on terms at least as favorable as those agreed upon, the buyer will be obligated to close.

Other closing conditions may be seen depending on the type of practice being sold. For example, a buyer of a medical practice with a significant hospital component may want admission to hospital privileges as a condition to closing. Other buyers may insist on issuance of a Medicare or Medicaid approval, or the acceptance of the buyer to the preferred provider list of certain insurance companies as a condition. Closing conditions can vary greatly from deal to deal, and will often change depending on the nature, location, and type of healthcare practice being acquired.

VI. CONCLUSION

The purchase of a healthcare practice, whether it is medical, orthodontic, dental, or even veterinary, requires a team of advisors that are well versed in the intricacies of the healthcare industry. CPAs and attorneys must be prepared to address the unique concerns and specific needs of buying and selling doctors. It is very helpful to have an understanding of industry standard practices and of the underlying preconceptions and biases that the doctors will bring to both sides of the transaction.

Healthcare professionals are very busy, often overworked, and they have very unusual schedules. This can be a challenge for advisors seeking to communicate with their clients during the course of a transaction. Therefore, the advisory team must be prepared to take the lead in pushing the transaction forward and in tempering their client's expectations with reality.

Finally, and above all, advisors to doctors buying or selling their healthcare practices must keep in mind that very often, the mental state and expectations of the doctors involved may be more important to the final outcome than the intricate details of the legal documents and cash flow calculations.