

**SELLING YOUR PRACTICE TO OR ACCEPTING EMPLOYMENT  
WITH A DENTAL MANAGEMENT COMPANY  
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The purpose of this article is to address the issues which should be considered prior to selling your dental practice to or accepting employment with a dental management company ("DMO").

**In General**

Recently, a number of physicians have sold their practices to physician management companies ("PMC's") with the purpose of gaining access to patients through managed care contracts.<sup>1</sup> Although some PMC's have been successful, others have not, i.e., Coast Physician Group.<sup>2</sup> Dentistry, however, is not dependent upon managed care contracts in the same manner as medicine. Therefore, factors other than the delivery of patients through managed care contracts should influence whether a dentist or dental specialist would sell to or accept employment with a DMO.

Practice productivity is generally on an increase.<sup>3</sup> As a result of this and other favorable practice statistics, it is becoming increasingly viable for a new dentist or specialist to establish a practice rather than purchase one. As a result, we are now seeing a purchaser's market. Therefore, if a DMO makes a proposal in a market with few purchasers to a dentist or specialist considering retirement, the offer may be tempting. Thus, all too often, dentists and specialists nearing the retirement mode attempt to sell their practices too early thereby losing the ability to control their livelihoods and missing significant opportunities to fund retirement plans.

For new dentists and specialists, the ability to attain a relatively substantial income early in practice, pay off school loans sooner than later and practice their profession without administrative, management and scheduling responsibilities may appear to be a sound alternative to acquiring or establishing a practice.

Due to the success of several publicly traded PMO's in an advancing stock market with a favorable environment for initial public offerings ("IPO's")<sup>4</sup>, several entrepreneurs (consisting of dentists, dental consultants, medical consultants, investors and others) are attempting to form

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<sup>1</sup>Collier, Sarner and Associates, Inc. Newsletter, Vol. XXIV, No. 18, Collier, Sarner and Associates, Inc., Ohio, September 15, 1996.

<sup>2</sup>Nikhil Deogun, "Bitter Medicine," The Wall Street Journal, September 26, 1996, p.1, col. 6.

Joe Blaes, D.D.S., "Dental Economics," How to Profit from Practice Analysis, October, 1997, pp 28, 91.

<sup>4</sup>The Blair/McGill Advisory, Issue 96-09, Blair, McGill & Company, North Carolina, September, 1996.

\*Wickens, Herzer & Panza, A Legal Professional Association, December, 1997

DMO's. Because only about fifty percent (50%) of the public have a general dentist which they visit regularly, with specialty treatment only slightly higher, and where approximately seventy-five percent (75%) of the practices remain solo, it is no wonder that DMO's are gaining popularity on Wall Street<sup>5</sup>, making the original creators and promoters wealthy in the process.<sup>6</sup> Currently, the Wall Street market for DMO's has been increasing ahead of the S & P 500<sup>7</sup> and there is no evidence that the trend will reverse in the near future. However, like other "fads", the DMO outlook may change for the worse once growth stops and cash diminishes.<sup>8</sup> For example, the May 20, 1996 *Forbes* article indicated that the founder of Orthodontic Centers of America, Mr. Lazzara, cashed out for \$62 million dollars and stated, "Kind of makes you wonder whether the sellers of the stock aren't smarter than the buyers".<sup>9</sup>

However, Orthodontic Centers of America and similarly situated DMO's servicing the orthodontic market have performed relatively well, in part, due to: (i) direct advertising, in that a large segment of the population in need of orthodontic services does not seek regular dental care and, therefore, cannot be referred by a general dentist; (ii) orthodontic practices being relatively profitable as compared to general dental practices; and (iii) other operational efficiencies.

Provided that DMO's are helpful to the profession and patients, there is nothing wrong with the creator-investors earning a healthy return. Granted, a DMO can and should provide a wide range of services: billing and collections, scheduling and record management, negotiating with insurers, recruiting staff, leasing the practice facility, purchasing equipment, credentialing, utilization review and quality assurance review.<sup>10</sup> These services are usually performed in exchange for a fee as a percentage of collections, as opposed to profits, or the DMO may actually own the practice (in states where this is permitted) and employ the dentist(s).<sup>11</sup> The question is whether the DMO structure will be a benefit to dentistry and the public. For example, in the event that DMO's do deliver quality care at reduced fees, such a system would be good for patients. This is in contrast to an increased emphasis on managed care, lower prices

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<sup>5</sup>Leif C. Beck, Editor, "How To Handle Dental Management Company Overtures," *Dental Practice Advisory*, Advisory Publications, Pennsylvania, August, 1997, pp. 1-4.

<sup>6</sup>Collier, Sarnier and Associates, Inc. Newsletter, Vol. XXIV, No. 20, Collier, Sarnier and Associates, Inc., Ohio, October 15, 1996.

<sup>7</sup>"Capital Cost Comments. . .", *In-Dent*, Sherlock Company, Pennsylvania, October, 1997.

<sup>8</sup>Kerry A. Dolan with Amy Feldman, "Braces For The Masses," *Forbes*, May 20, 1996, pp. 260-262.

<sup>9</sup>*Ibid.*

<sup>10</sup>Peter M. Sfikas, J.D., "Who's Minding The Store?" *JADA*, Vol. 128, October, 1997, pp. 1462-1465.

<sup>11</sup>*Ibid.*

<sup>12</sup>Wickens, Herzer & Panza, A Legal Professional Association, December, 1997

and increased profitability, which may lead to lower quality than in the traditional dentist or specialist owned and operated practice.<sup>12</sup>

DMO's are somewhat similar to the formation of "clinic practices" which flourished in the mid-seventies. Entrepreneurial dentists established multiple dental practices, which were and are primarily focused on the provision of dental care to those persons who do not customarily visit a dentist. These practices were usually located in non-traditional settings (e.g., shopping malls and strip centers). For the first time, it appeared that practice location was becoming a more prevalent factor than traditionally in the attraction of new patients. The clinic practices advertised for the first time, in contrast to traditional referrals from existing patients and dentist-community involvement. Additionally, clinic practices advertised reduced fees below those of the traditional private practice. With school loans and the cost of establishing a practice becoming increasingly high, the clinic practices provided the new dentist or specialist with a place to work, at least for the short term, and in many cases, for the long term, for those dentists or specialists who did and do not desire to become practice owners. During the time of clinic practice formations, traditional practice owners were both angry with and fearful of clinic practices, concerned that their patient base and flow of new patients would be diluted. However, for the most part, that did not occur.

Clinic practice owners, in most instances, did and do attempt to provide, by way of advertising, the highest quality services for the least cost. This is accomplished through operating efficiencies and volume. The problem for them was and continues to be operational control. This is the challenge which DMO's will face. Stated differently, if management fees for the DMO are from 15-20% of practice collections (and not profits), either revenues must increase, costs must decrease, or both. Of course, one way to decrease costs is for the former practice owner to pay the management fees out of his or her compensation as a DMO employee, if operational results are not as anticipated.

Today, DMO's are similar to the mid-seventies clinic practices with some variations. First, the clinic practices were owned by dentists; however, the DMO's are funded in part by outside investor capital and public offerings. Second, the DMO's are buying up practices in contrast to the clinic practices, which typically opened new practice locations. Therefore, it should not be surprising that several of the mid-seventies clinic practice owners are planning to revive their practice growth by becoming DMO's in the late-nineties.

### Seller Considerations

Irrespective of whether you sell your practice to a third-party dentist or specialist, a family member who is or becomes a dentist, specialist or a DMO, the DMO format will probably impact certain areas of your practice as follows: marketing and advertising, practice management sophistication through computer efficiencies, fee quotation and flexible payment and

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<sup>12</sup>Collier, Sarner and Associates, Inc. Newsletter, Vol. XXIV, No. 20, Collier, Sarner and Associates, Inc., Ohio, October 15, 1996.

\*Wickens, Herzer & Panza, A Legal Professional Association, December, 1997

financing arrangements.<sup>13</sup> This competitive threat should provide the practice owner with the incentive to address these business matters.<sup>14</sup>

It should be relatively straightforward that selling your practice to a DMO is a very speculative investment, in that "get rich quick" approaches to Wall Street investments rarely work.<sup>15</sup> DMO's are relatively new and do not have historical track records.<sup>16</sup> Thus, if your practice is sold for a combination of cash and stock in the DMO (e.g., 20% cash and 80% stock), you are at risk of losing the sum paid in stock. However, some DMO's may pay cash in full at closing in order to gain entry into a particular market. This would eliminate the problem of whether you, as the seller, are provided appropriate security for payments.

In a typical DMO acquisition proposal for a combination of some cash and stock, the profile of the practice owner who has the least risk in selling to a DMO is one who has significantly funded his or her retirement plan and who is not dependent upon the receipt of practice proceeds at retirement. If the stock does well, the retiring seller receives a windfall. Alternatively, the mid-career dentist or specialist with little savings, particularly one who must work for the DMO after the sale and pay management fees back to the DMO, probably should not consider the speculation of DMO stock.

A common concern of retiring dentists is the philosophy, work ethic and values of the purchaser. Upon your retirement from active practice in a sale to a DMO, you may not have the ability to control the identity of the dentist or specialist replacing you. Alternatively, the DMO may attempt to place the burden on you to find your replacement, a responsibility which should be carefully considered before accepting.

Selling to a DMO for a combination of cash and stock requires certain due diligence on the part of the seller. Typically, due diligence is completed by the purchaser to determine if the acquisition of your practice should be made and to determine the purchase price, terms and conditions of the proposed acquisition.<sup>17</sup> However, selling to a DMO requires that you complete certain seller "homework" with respect to your: (i) being paid the full purchase price when due; (ii) ability to provide the required management fees after the sale; and (iii) other responsibilities, e.g., remaining in the practice as an employee dentist or specialist for some period of time after the sale.

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<sup>13</sup>The Blair/McGill Advisory, Issue 97-04, Blair, McGill & Company, North Carolina, April, 1997.

<sup>14</sup>Ibid.

<sup>15</sup>Collier, Sarner and Associates, Inc. Newsletter, Vol. XXIV, No. 18, Collier, Sarner and Associates, Inc., Ohio, September 15, 1996.

<sup>16</sup>Leif C. Beck, Publisher, "My View--Don't Sell To A Practice Management Company!" Dental Practice Advisor, Advisory Publications, Pennsylvania, August, 1997, p. 2.

<sup>17</sup>William P. Prescott, M.B.A., J.D., The Practice Acquisition Handbook, Randall K. Berning & Affiliates, 1997, p. 21.

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Because you are probably dealing with a relatively new entity which will probably be publicly traded, it is critical to assess and analyze all information which would normally be addressed with respect to selling your practice or business to a public company. This is much different (and more difficult) than assessing the credentials of an individual purchaser of your practice.

As to due diligence, obtain every piece of information which you can locate on the DMO in question. Check all references as to the management team and investors, their backgrounds and dental experiences. The typical information with which you receive from the DMO will be DMO friendly. In essence, it's a written sales pitch which will tell you the goals and objectives of the DMO. These goals and objectives may or may not materialize<sup>18</sup>.

Ask for the DMO's S-1 proposal and Securities and Exchange Commission response, as well as any other Securities and Exchange Commission filings and documents. This public information tells you who is in the business<sup>19</sup>. Further, ask the DMO to provide in writing their track record for attaining these goals<sup>20</sup>.

Prior to releasing any information on your own practice, obtain information on the DMO. Thereafter, sign a confidentiality agreement with the DMO whereby information with respect to your own practice will not be used against you in the event that you do not sell your practice to the DMO in question. Distinguish the confidentiality agreement from a letter of intent, which outlines the terms and conditions of the sale of your practice. Unless you are absolutely certain that you desire to negotiate with only one DMO, be cautious in granting an exclusive right to negotiate for a specified time period. Any letter of intent should be drafted as a non-binding proposal, subject to the execution of definitive legal documents, in form and substance satisfactory to respective legal counsel for you, as seller, and the DMO. In other words, do not allow a letter of intent to have more meaning than you intend, e.g., a contract for the sale of your practice, payment of management fees and future employment with the DMO.

As a general proposition, a DMO will desire that you remain in its employ as a dentist or specialist for some period of time, e.g., five years. Remember, you will now be an employee of the DMO for this specified time and you may not like the manner in which the operation is run, particularly if the DMO is sold or merged. For example, one way for the DMO to increase revenues (irrespective of low profitability) would be to enter into the managed care contracts, a decision which would be outside of your control.

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<sup>18</sup>"Birner Dental Management Services, Inc." Perfect Teeth, Birner Dental Overview.

<sup>19</sup>Leif C. Beck, Editor, "How To Best Negotiate With A Dental Practice Management Company," Dental Practice Advisor, Advisory Publications, Pennsylvania, October, 1997, pp. 5-7.

<sup>20</sup>Ibid.

You probably would be required to provide the DMO with management fees from 14%<sup>21</sup> to 20% or more<sup>22, 23</sup> of yearly collections, as opposed to profit. In the event that the operational results of the practice do not achieve the required level of management fees, said fees would probably be payable by you, the seller, to the DMO. Therefore, to receive your anticipated compensation as an employee of the DMO and the purchase price for your practice through the DMO stock, profitability must increase at a rate equal to the management fees, irrespective of the number of increased hours which you will be required to work to attain the desired results. It is questionable whether such a result is realistic.

If the transition does not work out as anticipated, you would want your practice back in the event that you are not yet retired. Therefore, any covenant not to compete should be null and void under certain negotiated circumstances. Additionally, the DMO should be subject to a non-compete in the event that you reopen your practice. Further, you should have the ability to re-enter the premises under any lease (irrespective of whether you own the building), if necessary. Finally, you should have a "first" security interest on the practice assets or stock which you sold to the DMO.

Because DMO management contracts can run for 20 to 30 years (or more)<sup>24</sup>, you should understand all of your obligations, irrespective of whether you will be retired. For example, if desired operational results are not attained by the DMO after you sell your practice, you need to know your obligations, if any, to pay any portion of the management fees to the DMO.

Do not expect to sell your DMO stock quickly after the company has gone public. Typically, the Securities and Exchange Commission provides for a two year holding period prior to the stock being sold<sup>25</sup>. Additionally, public stock cannot be sold until the DMO goes public. Further, due to the activity with PMOs and DMOs, expect the Securities and Exchange Commission to impose additional restrictions in the future. This means that selling your practice to and owning stock in a DMO will become more, rather than less, complex.

In the event that a DMO is unsuccessful, it can close its doors, be merged or sold. Your continued obligations to the DMO under these circumstances should be considered and negotiated prior to your selling the practice to such entity. For example, your working relationship with

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<sup>21</sup>The Blair/McGill Advisory, Issue 96-09, Blair, McGill & Company, North Carolina, September, 1996.

<sup>22</sup>Anne L. Finger, "Physician Practice-Management Company Buyouts: Is Taking The Leap Worth The Risk?" Medical Economics, April 28, 1997, pp. 106-118.

<sup>23</sup>Mark Holoweiko, "Selling Your Practice: Is That Offer A Trap?" Medical Economics, July 28, 1997, pp. 134-150.

<sup>24</sup>The Blair/McGill Advisory, Issue 97-01, Blair, McGill & Company, North Carolina, January, 1997.

<sup>25</sup>Leif C. Beck, Editor, "How To Handle Dental Management Company Overtures," Dental Practice Advisor, Advisory Publications, Pennsylvania, August, 1997, pp. 1-4.

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the DMO may be very good after the practice sale. However, if the DMO is merged with another company or is sold, both management and operations may change. As a result, you could be very unhappy with the new DMO and wish to terminate your employment, be paid all sums due you immediately, take your practice back or have the ability to terminate the management agreement.

As to tax matters, it has been promoted that the sale of your practice can be accomplished on a "tax-free" basis, which is a misnomer. There are two ways in which to sell a practice or business: through the sale of stock or through the sale of assets.

In the event that your practice operates as a C corporation and if the DMO would agree to acquire the stock of your practice, which it would probably not agree to, then the sale of your stock may be classified as an Internal Revenue Code Section 168 reorganization. In this situation, gain may be deferred to the extent that your stock was exchanged for the DMO stock. However, any increase in the value of the DMO stock after the sale of the stock of your practice would be taxable upon its later sale.

A more likely scenario is that the DMO would agree to acquire the assets of your practice. It probably would not agree to acquire the stock because the DMO would not want any unknown or contingent liabilities associated with the purchase of your stock. Therefore, if your practice operates as a C corporation and said C corporation sells its assets, there are two levels of tax imposed: 35% at the corporate level and another tax at the selling dentist's or specialists's individual tax rate. In essence, there can be well over a 55% tax rate when a professional C corporation sells its assets. Therefore, the tax implications of any practice sale should be carefully considered and any management, consulting and deferred compensation arrangements should be handled in accordance with applicable federal tax regulations. Practices operating in entity forms other than a C corporation do not face the double taxation problem upon the sale of assets. Although the C corporation shareholder receives favorable capital gains treatment upon the sale of stock, the purchaser pays for stock in non-deductible, after-tax dollars. This is another reason why purchasers generally do not desire to acquire stock in a professional C corporation. However, in a stock sale, the tax benefit to the seller and tax detriment to the purchaser can be quantified and allocated or adjusted in some appropriate and fair manner.

There are certain considerations on the state and federal levels relative to selling your practice to a DMO. First, there are fee splitting concerns which vary from state to state. Essentially, state law regulates the relationship between the DMO and selling dentist or specialist who enters into a management arrangement for payment of fees to the DMO. In certain states and under certain fact patterns, various laws ban licensed health care professionals from splitting fees for professional services with another who did not perform the service<sup>26</sup>. Second, certain states may question whether the DMO is engaged in the unauthorized practice of dentistry<sup>27</sup>.

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<sup>26</sup>Peter M. Sfikas, J.D., "Who's Minding The Store?" *JADA*, Vol. 128, October, 1997, pp. 1462-1465.

<sup>27</sup>*Ibid.*

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Finally, the unbundling of fees may pose a problem under both federal antitrust law<sup>28</sup>, as well as under applicable state insurance laws. Therefore, the above matters should be reviewed and addressed prior to selling your practice to a DMO.

### New Dentist or Specialist Considerations

Working for a DMO can allow you as a new dentist or specialist to begin rendering professional services without the significant investment required to establish or purchase your practice. Additionally, the administrative and management responsibilities rest with the DMO. You would merely be providing professional services. Further, you would probably be provided the opportunity to acquire stock in the DMO, which may increase in value depending upon the success of the DMO.

However, in working for a DMO, you do not own your practice. Therefore, you cannot later, at retirement, sell what you do not own. Additionally, one of the benefits of ownership is the ability to answer to yourself and control your career and work environment. It is relatively difficult to maintain such control when working for a large company, although decision making responsibility depends upon the philosophy and management of the particular DMO. Finally, the single most important advantage of practice ownership is the ability to fund your retirement plan to the extent permitted by law; generally the lesser of 25% of your compensation or \$30,000. It is doubtful whether a DMO would provide such a retirement plan and you will not likely attain the maximum benefit permitted by law in a 401(k) plan sponsored by the DMO. Further, the DMO, and not you, will be making the decisions relative to the type, terms, eligibility requirements and vesting schedule of any retirement plans<sup>29</sup>.

### Conclusion

If you are considering the sale of your practice to a DMO for a combination of some cash and stock, recognize the speculative nature of such a transition and your obligation to pay the DMO any management fees after the sale. Understand that you may be required to work in an untenable environment after the sale without any control over your former practice or employees. Obtain an appropriate confidentiality agreement and letter of intent. Be extremely thorough in your due diligence and begin your due diligence efforts prior to providing the DMO with any information regarding your practice. Finally, recognize the significance of the tax aspects of the sale of your practice. In short, think long and hard prior to selling your practice to a DMO in light of your other options, e.g., a third-party dentist as purchaser or whether to sell at a particular point in time.

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<sup>28</sup>Leif C. Beck, Editor, "How To Best Negotiate With A Dental Practice Management Company," Dental Practice Advisor, Advisory Publications, Pennsylvania, October, 1997, pp. 5-7.

<sup>29</sup>William P. Prescott, M.B.A., J.D. Business, Legal, and Tax Planning For The Dental Practice, Penwell Publishing, 1994, Preface.

<sup>30</sup>Wickens, Herzer & Panza, A Legal Professional Association, December, 1997



Be cognizant that as a new dentist or specialist you cannot at a later date sell what you do not own. You probably did not go to dental or graduate school and/or complete your residency to not own all or a portion of your practice. Recognize that the most significant benefit of practice ownership is the freedom to adopt and fund your retirement plan to the limits provided under the law, while retaining the ability to control the quality and quantity of work produced by you and your team.