

Quarterly Supplement To

Business, Legal, And Tax Planning for the Dental Practice

Second Edition

The purpose of the Quarterly Supplement is to continually update the material contained in **Business, Legal, And Tax Planning for the Dental Practice**, Second Edition, as "free-standing" articles relative to current business, legal, tax and pending legislative matters that affect your practice. These Quarterly Supplements also reflect my ongoing experiences as an attorney representing dental and dental specialty practices. At times, articles will be written by friends who consist of tax attorneys, accountants, actuaries and dentists. The articles contained in the Quarterly Supplements are consistent with the chapters contained in my book, which you may download at www.wickenslaw.com — click "Dental Practice" at no charge.



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Selling Or Acquiring Your Practice – Do You Need A Letter Of Intent?

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SELLING OR ACQUIRING YOUR PRACTICE – DO YOU NEED A LETTER OF INTENT?

A letter of intent is an optional letter agreement which precedes preparation of the purchase and sale agreements. Sometimes a letter of intent is prepared by the attorney, advisor or broker who represents the seller and sometimes by the purchaser's attorney or advisor. There are two reasons for writing this article. First, a number of advisors believe that a letter of intent is unnecessary. Second, some of the letters of intent that I have reviewed recently have not adequately delineated the important provisions of the purchase and sale. As a result, the parties often get into disagreements on important terms at the "eleventh" hour.

This article is limited to a letter of intent in a complete purchase and sale of a dental or dental specialty practice and does not consider the more detailed and very necessary "letter of understanding" for "partnerships" or "co-ownership". A letter of understanding is more detailed than a letter of intent for a complete purchase and sale because we consider the three categories of "partnership"; the buy-in, operations and the buy-out. All categories need to be considered and the buy-out usually gets the least attention. Adding to the complexity is that there are three basic business and tax structures for partnerships.

Is a Letter of Intent Necessary?

I believe so, because a well drafted letter of intent considers all key terms and contingencies of the purchase and sale in advance of paying lawyers to draft and review agreements. Here are some recent examples of disagreements over key terms that I have seen.

Purchase Price and Payment Terms. A purchaser received multiple draft versions of agreements have been prepared by the seller's legal counsel and the doctors have not yet agreed to the purchase price and terms of some component of seller financing in this very large specialty practice. A letter of intent was never prepared.

Restrictive Covenant. The seller is relocating from the midwest to the south, yet there is disagreement over the radius of the restrictive covenant and the purchaser now questions whether the seller is really relocating and now why the practice is being sold. The broker, with good intentions, did not want a letter of intent prepared and wanted to go directly to preparation of agreements because he thought it would save time. It did not. In another example, the seller sold a satellite office and continues to work in the primary practice facility, roughly 12 miles away. Why is it always 12 miles? Here, the seller agreed not to directly solicit patients of the satellite location, but if a former patient requested to be treated by the seller, the seller would pay the purchaser for the goodwill attributable to that patient. The formula was the value of all goodwill purchased, divided by the number of agreed upon active patients. A protocol was also in place so that the purchaser would be informed if a patient left the purchaser's practice to be treated by the seller.

Orthodontic and Other Unique Cases. The general dentist/seller would not agree to complete orthodontic cases, even though the purchaser, who does not perform orthodontic procedures, agreed to make arrangements for and pay the seller to do so.

Purchase Price Allocation. The accountant for a purchaser wanted to allocate one-half of the purchase price to dental equipment to obtain favorable amortization at the expense of the seller when the equipment was worth roughly 15% of the purchase price. The disagreement was settled by having the dental equipment and supply company that repaired the equipment for the practice complete an appraisal of its fair market value. It turned out to be 15% of the purchase price.

Continued Employment or Engagement Post-Closing. The seller sold the practice and insisted on continued employment for three years following the sale. The purchaser was unsure that there were sufficient patients and production for both dentists.

Release of Seller as Guarantor Under the Lease. A seller refused to sell the practice unless the purchaser would agree to release the selling dentist as a guarantor under the seller's lease for the practice premises. The purchaser was not a party to the lease and could not make such a representation. In addition, the lease specifically stated that the selling dentist would remain a guarantor under any assignment, should such an assignment be granted by the landlord, in the landlord's discretion. Tip! Get a favorable assignment provision in your lease prior to selling your practice, unless your own your building.

Each of these disagreements could have been avoided had a well drafted letter of intent been prepared. Unfortunately, it is not uncommon for agreements to be prepared and distributed without the parties having agreed to the purchase price, payment terms, length and radius of the restrictive covenant, completion of specialty or other unique cases, purchase price allocation, continued employment or engagement of the seller post-closing or the landlord's release of the selling dentist from the facility lease, to name a few.

Letters of intent often provide for an earnest money deposit. In exchange for an earnest money deposit, the purchaser expects the seller to remove the practice from the market until closing, which may be several months in the future. It is rare that a purchaser has the ability to obtain an earnest money deposit sufficiently large enough for the seller to take the practice off the market because the lender uses the practice, not the purchaser, as security. The earnest money deposits that I usually see are roughly \$5,000 and would be returned upon the occurrence of certain contingencies. Those contingencies are often death, disability, inability to obtain financing, inability to obtain a lease assignment or lease for the practice facility, the purchaser or purchaser's advisor(s) uncovering a problem in the purchaser's due diligence or homework process or the inability for the seller, purchaser and their respective advisors to agree on the provisions of definitive legal documents for the purchase and sale. The last contingency is a "catch all" provision meaning that the purchaser can usually get the deposit back and the seller has lost valuable time. While the \$5,000 does show good faith, my recommendation for the earnest money deposit is to eliminate it entirely and not take the practice off the market. Yes, there are exceptions.

Letter of Intent Provisions

1. The Parties and Acquisition. The parties to the transaction(s) need to be identified. When the practice is organized as a C-corporation or an S-corporation that was previously a C-corporation within ten years, there will be two sellers, the C-corporation and dentist who sells his or her personal goodwill. On the purchaser's side, it is probably not the individual dentist, but the entity, through which the purchaser will practice, that it is the purchaser. If the selling dentist or dentist and spouse own the real estate, the real estate will, hopefully, be owned by a limited liability company. Possibly the members will be a family trust. The purchasing dentist would, hopefully, also form a limited liability company to purchase any real estate.

2. Purchase Price, Payment and Purchase Price Allocation. The purchase price for any C-corporation's tangible assets and corporate goodwill should be separated from personal goodwill of the dentist/seller. Tip! Any personal goodwill should be separately appraised. The purchase price for any real estate should also be separate and, hopefully, will be a different seller and purchaser. The collective purchase price for the tangible assets, corporate goodwill (if any) and personal goodwill is delineated as are the payment terms, usually fully payable by wire transfer, bank, or certified check at the closing of the purchase and sale. The purchase price would be typically reduced by any earnest money deposit, liens on the practice or brokerage fees paid to a broker. Finally, this provision provides for the purchase price allocation as designated in a schedule to the letter of intent. The purchase price allocation designates how the seller(s) is taxed on the sale and how the purchaser amortizes the purchase price, including goodwill, be it corporate, or personal to the selling dentist or specialist.

3. Excluded Assets. Certain items will be excluded from the purchase and sale, such as seller's accounts receivable (although not always), cash, cash equivalents, and any personal items of the selling dentist, and any of the seller's debt, unless specifically assumed by the purchaser.

4. Accounts Receivable. In the event the accounts receivable are not purchased by the purchaser, the purchaser typically collects the accounts receivable for a period of six months following closing, less an administrative fee of five percent. After six months, the list of unpaid accounts receivable is turned over to the seller with no further responsibility for collection by the purchaser. The accounts receivable are typically collected by the purchaser on a first-in, first-out basis, except for third party provider, dental insurance, and/or payments relating to specific dental treatment provided by the purchaser through the purchasing dentist. In orthodontic practices, my recommendation is for the purchaser to receive the accounts receivable in exchange for agreeing to complete the prepaid cases at no charge to the seller. To the extent that the prepaids exceed the accounts receivable, the purchase price is offset.

5. Assets Free and Clear of Liens and Encumbrances. This provision provides that all purchased assets will be free and clear of all liens and encumbrances at closing, unless specifically assumed by the purchaser as a schedule to the sale and acquisition agreements.

6. Brokerage Fees. This provision provides that all brokerage fees will be the sole responsibility of the seller.

7. Earnest Money Deposit. In the event that there is an earnest money deposit, this provision provides for the delivery of an agreed sum by the purchaser to the seller's legal counsel, as designated escrow agent. The escrow agent may also be a broker or the selling dentist. The earnest money deposit is retained by the seller as liquidated damages, and not as a penalty, if closing doesn't occur for any reason, except for certain contingencies specified in the letter of intent. Upon the occurrence of any contingency defined in the letter of intent, the earnest money deposit is promptly returned to the purchaser or the purchasing dentist's guardian or estate.

8. Confidentiality. While this provision may be in a letter of intent, it should be in an earlier prepared and separate confidentiality letter or agreement signed by the purchaser. The reason for this is that no purchaser should make an offer on a practice without review of the appraisal, financial information and other relevant information as part of the purchaser's due diligence investigation. A confidentiality provision provides that the purchaser will have access to confidential information regarding the seller and seller's patients and/or referral sources, as well as financial information and that the confidential information will remain the property of the seller, the purchaser shall keep the information confidential, except for the purchaser's advisor(s), and return it if negotiations cease for any reason.

9. Due Diligence. If this provision is included in the letter of intent, it provides that there will be a specified due diligence period for the purchaser to review the confidential information regarding the seller's dental or specialty practice and if the purchaser or purchaser's advisors are not satisfied with the due diligence investigation, any earnest money deposit is returned to the purchaser.

10. Closing. This provision designates the date that closing will occur on or before a specified date, unless otherwise agreed to by the purchaser and seller in writing.

11. Representations and Warranties. Seller provides the purchaser with customary representations and warranties that will be contained in the purchase and sale agreements.

12. Non-Competition/Non-Solicitation. This provision spells out the restrictive covenant and non-solicitation provisions that will be contained in the purchase and sale agreements for solicitation of patients and/or referral sources and former employees of the seller, irrespective of the geographic radius of the restrictive covenant. The restrictive covenant will be in effect for a specified number of years after the selling dentist is no longer employed or engaged by the purchaser's dental practice and within a specified radius or map in all directions from the premises of the seller's practice.

13. Post-Closing Employment of the Seller. This provision should provide that, at the purchaser's discretion, the selling dentist will remain employed or engaged by purchaser's dental or dental specialty practice for a specified period, e.g., one year after closing and by mutual agreement thereafter. This provision designates the selling dentist's compensation (reduced by any benefits and direct business expenses) for such period, which will probably be a

percentage of collections for the rendering of professional services with a minimum daily or hourly rate for introductory and administrative services. This provision should also provide that, to the extent that the purchaser no longer needs the selling dentist's services, the purchaser may terminate the selling dentist's employment or engagement with the purchaser's dental practice with 30 days' notice.

14. Financing. This provision provides that the purchase and sale is contingent upon the purchaser obtaining "reasonable" financing for the purchase price on or before closing.

15. Lease Assignment, Lease and Real Estate. This provision provides that the purchaser will obtain a reasonable lease assignment or lease for the practice premises on or before closing. If the real estate is owned by the selling dentist and/or spouse or in a separate limited liability company, there may be an option and/or right of first refusal for purchase of the real estate at fair market value with provisions that designate how a disagreement with the appraised value is dealt with. If the real estate is purchased simultaneously with the practice, the letter of intent will spell out all details, including the completion of any environmental audit(s) and payment thereof. There may also be a mandatory purchase of any real estate at a certain point in the future.

16. Death or Permanent Disability. This provision provides that the purchase and sale is contingent upon the purchasing dentist not becoming disabled or deceased prior to closing. A specific definition of disability and selection of a physician is important to determine whether a disability has been incurred by the purchasing dentist.

17. Retreatment. This provision provides that the purchaser is not responsible for retreatment of the selling dentist's patients and a provision in the purchase and sale agreements should provide how retreatment is to be determined for those patients treated 12 months prior to closing, particularly if the purchasing and selling dentists disagree on the necessity of any retreatment.

18. Work-In-Process. This provision provides that the selling dentist will be permitted to complete cases started, but not finished, prior to closing. The seller customarily retains all fees for work-in-process and is responsible for payment of supplies, laboratory fees and use of any chairside assistant employed by the purchaser. The days and times that the seller is permitted to complete such cases should be set forth by a schedule. Additionally, this provision should specify that the purchaser in a general practice will not be responsible for continued treatment of any orthodontic or other defined cases previously started by the seller.

19. Mutual Indemnification. This provision provides that the seller and purchaser will hold each other harmless for the operation of the practice prior to and after closing. The seller will indemnify and hold the purchaser and purchasing dentist harmless from all aspects of the seller's operation of its dental practice prior to closing and the purchaser will indemnify and hold harmless the seller and the selling dentist for all aspects of the purchaser's operation of its dental practice following closing.

20. Definitive Legal Documents. This provision provides that the purchase and sale is expressly contingent upon and subject to the preparation of legal documents in form and substance satisfactory to the purchasing dentist, the selling dentist and their respective legal counsel. In other words, if the purchasing or selling dentist or specialist is not satisfied with the legal agreements, the purchaser usually gets any earnest money deposit back.

You tell me, after the examples of disagreements over key terms and the many important provisions that should be considered in the purchase and sale of a practice, isn't a letter of intent important?