THIS BOOK IS NOT INTENDED TO PROVIDE SPECIFIC LEGAL OR TAX ADVICE

This book is not intended to provide specific legal or tax advice. For specific solutions to legal and tax matters, please consult with your legal counsel and CPA.
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JOINING AND LEAVING THE DENTAL PRACTICE
SECOND EDITION

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PREFACE


The purpose of Joining And Leaving the Dental Practice is to educate you, your spouse and advisors on all important business, legal and tax planning issues relative to your practice succession or entry choices. This book recognizes that in any form of practice transition, you have a silent partner, the IRS, specifically in the complex area of co-ownership discussed in Chapter 11.

A friend once jokingly suggested that I write a book titled "Nothing But the Tooth!". Maybe this is as close as I get to it.

Please enjoy and provide me with your comments, questions and suggestions.

As always, I am grateful for my wife Mary Lou being here.

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Chapter 1

READY, SET, RETIRE!

Your new dream is to now get out of practice or get help through an associate. You're getting worn out and you see a changing patient demographic in clinics all around you who advertise on television and through other media. What are the issues to consider, what are your choices and how do you make a soft landing with minimum stress? Making this strategic decision usually takes about two years. Why is this important? Because when I teach exit strategies, fewer than five percent of attendees have a plan. This also means that you probably have no ongoing strategic plan for profitable practice operations. But don't feel bad, lawyers and accountants are in the same percentage.

Planning Issues

Attached as Figure 1-1 is a checklist of issues in question that you need to figure out before selecting and evaluating your exit choices. While somewhat self-explanatory, the biggest questions to me are "can I afford to retire?" and "what will I do with my time?" However, "will we have quality health coverage after retirement?" is quickly climbing on the list as continued coverage is essential. Make sure that you understand your reasons for retirement. If it is because your practice has you burned out, "get back in the saddle" through practice management. Help is available.

Authorize Preparation of the Practice Valuation

Irrespective of your exit choice, timeline for retirement or the possibility of your death or disability, you need to know what your practice is worth. In years prior to retirement, you cannot increase value unless you know the current value. Valuation reports can also be easily updated yearly once initially prepared. Of the 30 factors I listed in Figure 5-1, the most significant are collections per year and owner profit percentage. With the valuation report prepared, both of these items can be monitored and improved over time. Your advisory team can refer an experienced dental appraiser to you if your existing team members do not prepare appraisals.

Authorize a Systems Review and Preparation of Monthly Financial Statements / Meet With Your Advisory Team Regularly

Your management consultant can be engaged to review, update and implement your practice systems to increase practice value. Additionally, your CPA should be preparing monthly, at least quarterly, financial statements by meaningful expense and profit categories. The CPA and management consultant should coordinate on the expense and profit line items. Meet with your accountant twice and attorney once per year to review the operations, update your succession plan and implement year-end planning.
Locate Your Successor

Your candidate search is dependent upon your exit choice. Unless you have made this choice, you do not know who to look for. How do you find your successor? Brokers have become very predominant, mostly in general practices, where complete purchase and sale is contemplated in exchange for 10% of the selling price. While I know of brokers in orthodontics and endodontics, I have not found any in other specialties. JADA, as well as state and local dental societies have advertising pages in their journals. Dental schools have an executive director or someone who will pass on your name to students, residents or former graduates. Finally, dental equipment and supply companies keep very good tabs on available candidates. Before interviewing any candidate, carefully consider the interview process, get a confidentiality letter signed and a release to investigate references.

Authorize Preparation of a Letter of Understanding

The letter of understanding or letter of intent delineates all relevant terms of the exit choice. This is as much for your benefit and advisory team as it is for your successor candidate and his or her advisors. If your exit choice is not in writing, it probably won't work well.

Especially for Co-Ownership, Authorize Preparation of Agreements

Agreements are prepared from the letter of understanding or intent. Particularly with co-ownership, the agreements should be prepared before the associate picks-up a handpiece. Dealing with the buy-in, buy-out, profit allocations, decision making control after the associate starts will only lead to later disagreements. I sometimes hear that "if the associate does not work out, I will have paid unnecessary advisory fees." Not only does preparation of the agreements assist to ensure the success of the transaction, but if your exit choice is the right one, the identity of the candidate will not matter. If Dr. Juni or doesn't join you, you will look to Dr. Smth or Dr. Jones.

Don't Forget the Real Estate

The general rule is if you are no longer an owner of your practice, you no longer need the real estate. While there are exceptions and the rent is desirable, you should dispose of your practice real estate or interest because the tenant could move and you could have an empty facility. On the other hand, if your practice is not the only tenant or best use, retain it and sell when you choose. Given real estate turmoil over the recent past, there may be a minimum price. The purchaser may rent with an option to purchase that becomes a mandatory purchase at some specified time. Stay away from traditional rights of first refusal because it is almost impossible to obtain a legitimate third party offer where a right of first refusal has been granted. This also applies to your practice. A modified right of first refusal works well. You notify the purchasing dentist or specialist when you are ready to sell and the definition of fair market value and appraisal methodology would be the same process as for an option to purchase the real estate, with a limited period of time for your successor to decide to purchase or not. If the real estate is sold to a third party, the sale would be subject to the practice purchaser's lease and any renewal options.
Seller Due Diligence

You need to know all you can about your successor. Every doctor wants the best possible care for his or her patients upon retirement. If practice philosophy, work ethic and technical abilities are inconsistent with yours, then there may be some problems. This is a phase of seller homework or due diligence.

If you are providing financing for any portion of the purchase price, you need to ensure your payment and you will need to know the incoming doctor very well. And if the incoming doctor will be joining your practice as an associate, you may wish to know a little bit about that person prior to working together, possibly through an initial apprenticeship. Putting energy and effort in the interview process can save you much grief, money and time by finding the "right" doctor to succeed you.

Exit Choice

A complete purchase and sale is the least complex. You get fair market value for your practice and goodwill paid in cash. If you have identified your successor and are significantly busy, admitting an associate with a complete sale in one to three years is workable. Although more complex than a complete purchase and sale, if you plan to practice full-time for seven plus years, co-ownership can work so long as Dr. Junior is willing to purchase the second half of your practice on a mandatory basis. A solo group arrangement option works better than co-ownership because Dr. Junior probably does not want to purchase the second half of your practice. A merger can work well for an otherwise unsalable practice. Finally, you can work for an additional one or two years and then walk away.

The Soft Landing

If you want to retire, can afford to retire, know what you will do with your time and have selected your exit choice, you are ready to go once your successor is located. Make sure, however, that you maintain health coverage for you and your spouse.

Assemble your advisory team and understand how they are paid. Your advisory team should consult with you on the best exit choice in your situation. Authorize preparation of the practice valuation with an experienced dental appraiser. Your advisory team should know who can provide the systems review. Authorize preparation of meaningful accounting reports by your CPA. Schedule a series of meetings with your advisory team either in person, via telephone or video conference. Once you delineate your exit choice, your successor needs to be located and interviewed. Authorize preparation of the letter of understanding prior to preparation of detailed agreements, especially for co-ownership. And don't forget the real estate. It's not that easy. Hope this map helps!
Figure 1-1

EXIT CHOICE QUESTIONS

1. When do I want to retire?
2. Can I afford to retire?
3. Is my retirement complete or will I continue to practice part-time?
4. What will I do with my time?
5. Do we have a financial plan in place?
6. Have we adjusted my financial plan to account for retirement and a reduction of income?
7. What is our health status?
8. Will we have quality healthcare coverage after retirement?
9. Why do I want to retire?
10. Have our Wills, Powers of Attorney and estate plans be updated?
Chapter 2

EXIT CHOICES

Exit or succession choices are finite in number. They are a complete sale, hire an associate with a later sale, co-ownership, solo group arrangement, merger, and walk away.

Complete Sale

A complete sale remains the simplest exit choice. It's not that a complete sale is simple, it's that with the exception of closing the doors, the other exit choices are complex. Unlike 20 years ago, you should be fully paid in cash. For very large practices, there may be a component of seller financing, e.g., 20% of the selling price.

Depending upon the size of your practice, your continued employment by the purchaser should be as needed to transfer you goodwill, finish cases and provide treatment as requested by the purchaser for an agreed time period, e.g., six months to one year and by mutual agreement thereafter. If the purchaser no longer needs your services, e.g., after 90 days, you're out. You would be paid at the greater of a daily rate or half day rate or an agreed percentage of collections, e.g., 35%. The daily rate accounts for greeting and administrative time and assures that if you work, you will be paid irrespective of your treatment schedule. Your direct business expenses, insurances and benefits not paid by the purchaser's practice would be reduced and offset from your pay. While you and the purchaser would like to classify you as an independent contractor, you are an employee.1

If you need continued employment, you're not ready to sell, just keep working until you are. Don't worry about selling your practice in your best year if you aren't ready to go.

Hire an Associate With a Later Sale

To the extent that you have a practice that requires strong mentorship to transfer or you believe that you have located the right successor, but you are not ready to retire, this exit strategy has merit. Here, you and the associate sign the associate employment agreement, the purchase and sale agreements and your post-closing employment agreement. The purchase and sale agreements become effective one to three years from the date of the associate's employment or the earlier of your death, permanent disability or election to retire. Because this exit strategy often involves a large practice that can support an associate, it is more likely here, than with a complete sale, that you will continue to work after the sale.

I have found this exit choice to be a very desirable alternative to co-ownership where you plan to work less than six years. In this period of time, the associate could not pay for the first half of your practice. As an example, the associate works for you for three years, then you work for the associate for three years and by mutual agreement thereafter. If the new owner fires you


without cause, your restrictive covenant becomes null and void. Similarly, if you do not sell your practice under the terms of the agreement, the associate's restrictive covenant may become null and void.

Because you take your practice off the market by this arrangement, I suggest an earnest money deposit in the form of a promissory note, should the associate not purchase your practice except for specifically delineated reasons. You may also be subject to an identical promissory note should you decide not to sell your practice to the associate. The amount, usually $25,000 or $50,000, would be immediately due and payable upon default.

As a failsafe, if financing is not available in the future, despite the purchaser's best efforts, either the obligation to purchase your practice becomes null and void or the terms of your financing are delineated.

**Co-Ownership**

Co-Ownership is the most complex form of practice ownership because you need to address the buy-in, an owner's buy-out for any reason, compensation allocations, decision making control and employment of family members as dentists/specialists or non-doctor staff. Added to this complexity, there are three business and tax structures for co-ownership, two of which do not work very well if the tax rules are followed. Remember, your third partner is the IRS.\(^2\) Notwithstanding this, co-ownership is becoming more and more common due to large general and specialty practices that cannot be sold in a complete sale due to size. Make sure that you engage advisors who follow the tax rules and you will be fine. Unfortunately, the tax laws are not friendly to co-ownership.

As to the buy-in, it will be internally financed unless you are willing to provide the lender with a guaranty through your practice entity and/or you personally. If the new owner leaves, you would have to repay the loan. Thus, the buy-in should be internally financed. As to the buy-out, you should be paid in cash and your buy-out is mandatory by the associate. Unfortunately, the associate may not desire to buy the second half of your practice and buy you out. In my view, this is the biggest problem of co-ownership; second only to production disparity.

**Solo Group Arrangements**

Solo group arrangements are a good alternative to co-ownership because the associate who purchases the first half of the practice is not obligated to purchase the second half. Because you and the associate, now an owner, have separate practices, you sell your practice at retirement to a third dentist. In a solo group arrangement, you sell one-half or an undivided interest in your equipment and technology and an undivided interest in your personal goodwill. Thereafter, you and the new owner, your former associate, operate your practices pursuant to an office sharing agreement. Common expenses to both practices are either equally allocated or allocated on the basis of your respective productivity.

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Merger

For those practices that are relatively small or unsalable for any reason, you can merge into a larger practice with adequate space. You continue to work and when you're ready to retire, the host's practice purchases your patients, usually under an agreement over 12 months. This is often 35% of the host's collections attributable to your goodwill or revenue generated from your patients. The host only pays for your goodwill actually transferred. There may be an initial payment upon your retirement, e.g., half of the anticipated goodwill value.

Walk Away

Assuming that you can afford to retire, you can elect to work one or two years longer than anticipated and then close the doors.

As an example, your practice collects $800,000 in a year. Your earnings are $320,000 or 40% of collections. By working two more years, you earn $640,000, maybe $500,000 if you take off more time. If your practice sells for 65% of one year's collections or $520,000, you haven't lost anything. If a successor is available when you are ready to leave, you sell. If not, you walk away.

Some specialists in certain geographical areas have no choice other than to close the doors should a successor not be available. While you aren't paid for your practice, you are not faced with the complexities of selling it.

Summary

Assuming that your retirement is by choice, it should be an event to be celebrated, not a hassle to complete. You have completed your exit planning, are informed of your choices, so how do you get out on your terms?

Assemble Advisory Team

Assemble your advisory team early with advisors experienced in dentistry and its specialties. Start with your accountant and attorney and add others as called for. Experience is important because you should expect your advisors to counsel you not only on the obvious, but on what's missing. Always understand how your advisors are paid with advance fee arrangements in writing. Work with your team to delineate the project schedule. You should expect your advisors to do the work properly and professionally, in accordance with a predetermined schedule and within budget.

Select Exit Choice

Work with your team to choose the right exit choice for you. This crucial step needs to be the right choice for the right reasons. For example, you may think that because you are a busy one and one-half doctor practice, it would be a good idea to relocate and take in an associate for future ownership. What you probably need is practice management to get your systems in place rather than an associate. You should also look closely at your fees. If you have now relocated, you have already made your choice, probably the wrong one. This is where
experienced advisors are needed to consult in advance of any relocation or expansion. The more
time you have to plan ahead, the better the result. I like planning for exits five years out at a
minimum. Five years working with your management consultant can increase revenue and
profitability to significantly raise practice value.

A complete purchase and sale is the least complex. If you get fair market value for your
practice and goodwill and paid in cash. If you have identified your successor and are sufficiently
busy, admitting an associate with a complete sale in one to three years is workable, although
more complex than a complete purchase and sale. If you plan to practice full time for 10 plus
years, co-ownership can work so long as Dr. Junior is willing to purchase the second half of your
practice on a mandatory basis. A solo group arrangement often works better than co-ownership
because Dr. Junior probably does not want to purchase the second half of your practice. A
merger can work well for an otherwise unsalable practice. Finally, you can work an additional
one or two more years and walk away. You have to pick one!
Chapter 3

ENTERING PRACTICE — MAKE THE FIRST CHOICE THE RIGHT CHOICE

Your practice entry choices are to establish a practice, purchase a practice either immediately or associate and then purchase the practice in one to three years, associate and later be elevated to co-ownership, associate and enter into a solo group arrangement or become a permanent associate.

Practice Option Report

In deciding upon alternative options, prepare an analysis, in light of your personal goals and financial situation. The "Practice Option Report" in Figures 3-1 and 3-2 provides an analysis of the qualitative and quantitative factors for each option.

Qualitative Considerations

The qualitative portion of the Practice Option Report should consider your goals and practice objectives in terms of the following categories: (a) the demographics of the patients you desire to attract, income, age, etc.; (b) the method by which you expect to be paid for your rendering of professional services, fee for service, insurance, managed care, etc.; (c) the mix of procedures which you expect to perform; (d) the geographical area where you intend to practice; (e) the geographical area where you intend to live; (f) the form of practice in which you intend to operate (establish a practice, acquire a practice, acquire a portion of a practice/practice merger, operate in a shared solo-facility format or associate); (g) a statement of your mission practice philosophy; (h) a statement of your commitment to continuing education; (i) a statement of your commitment to learning the business of dentistry or your specialty; (j) the characteristics of the practice, its assets and facility which you intend to operate from, size of facility, rent or own your building, number of treatment rooms, revenues per year, the number of hours which you intend to work per week, etc.; (k) a statement of your dedication to community involvement, etc.; (l) a statement of your personal and family objectives; and (m) any other category which you deem relevant. This list of categories is included in Figure 3-1, "Practice Objectives." Unfortunately, your goals for entering practice may be limited by available opportunities in the geographic area where you want to live and practice. This does not mean that you need to give up and compromise. You just need to watch and wait.

Quantitative Considerations

The "Practice Option Matrix" contained in Figure 3-2 is an example of the quantitative segment of the Practice Option Report. The Practice Option Matrix provides a format for you and your accountant to prepare a long term business plan, designed to assist you in choosing your desired form of practice. The Practice Option Matrix should be utilized not only to compare the options of practice form, but to compare the available options within one category, e.g., practices available for sale, associateships, etc.
The Practice Option Report should be in writing and typed so that it is complete. Unfortunately, the preparation of the Practice Option Report takes substantial effort, as does the preparation of any formalized business plan. Nevertheless, one method to obtain the practice you want is to formally plan for your results. After you're in practice, the Practice Option Report should be continued in the form of an ongoing strategic practice plan. This should provide you with a reference point to assess your continuing progress toward your goals and objectives. The strategic practice plan also allows you to reexamine your decisions and goals, in light of a changing economic, political and social environment.

**Establishing a Practice**

To the extent that you have the ability to successfully establish a practice, you have no need to consider other options, e.g., purchase a practice. However, you may choose to establish a practice and associate elsewhere, on a part-time basis, in order to support your family. In such case, you would be analyzing two options. The most difficult phase of the analysis to establish a practice is the analysis of revenue for the first 2-3 years. The expenses are much easier than revenue to analyze.

**Purchase a Practice**

The purchase of a practice should provide you with an immediate patient base, staff and practice facility. You are immediately in practice after the acquisition. The economic cost, and associated benefit, of purchasing a practice would typically be weighed, prior to the purchase, against other options, e.g., establishing a practice.

The primary consideration in acquiring a practice should be to ensure that you receive what you pay for. That is, you are acquiring: (a) certain tangible assets, consisting of dental equipment, office equipment, furniture, leasehold improvements, plumbing, electrical and carpentry, etc., dental supplies and office supplies; and (b) more importantly, the goodwill or going concern value of the practice and Dr. Senior(s), e.g., the patient and/or referral source base. Unless you believe that the patient and/or referral source base will remain with the practice after its purchase, you should not proceed further.

**Associate and Later Be Elevated to Co-Ownership**

In acquiring a portion of a practice or in merging two or more practices into one, you are placing yourself in a co-ownership arrangement. While there are advantages to co-ownership arrangements, expense sharing, mentorship, coverage of practice(s), sharing of ideas, etc., certain points should be considered to minimize the potential for dispute. Those points are: (a) decision making control; (b) the buy-out of other owner(s); (c) the expense sharing formula; (d) the compensation allocation formula; (e) the ability of the practice to continue or replace the production of Dr. Senior upon retirement; (f) the expense level in the event of the departure of Dr. Senior; (g) restrictive covenants in order to protect the practice from competition by Dr. Senior; and (h) employment of spouses and other family members.
Associate, Then Enter Into a Solo Group Arrangement

In a solo group arrangement, you associate, then purchase half or an undivided interest in half of the tangible assets of the practice. You will also purchase an undivided interest in Dr. Senior's goodwill or the patient base of Dr. Senior's patients that you customarily treat as an associate. For example, the goodwill may equate to 50% of your yearly production at the time you enter into the solo group. At that time, you would form a separate practice from Dr. Senior.

In this format, you and Dr. Senior would operate your respective practices pursuant to a written office sharing agreement. This agreement would provide for the allocation of all expenses, distribution of non-referred new patients, maintenance of the premises and certain other matters. Additionally, your practices would be subject to a buy-sell/dissolution agreement which would provide for the departure of any owner, for any reason, from the shared facility.

The benefits of a solo group are to: (a) share expenses; (b) maximize use of the practice facility; (c) provide coverage for each practice in the facility; (d) provide a purchaser in the event of death or disability of an owner; (e) retain independence so that you and Dr. Senior avoid the complexity of co-ownership; and (f) most important, unlike in co-ownership, escape the obligation to buy-out Dr. Senior at retirement.

Associating

While there are benefits of associating with an existing practice in that you are employed and have the opportunity to learn and grow professionally, you do not own it. Hopefully, your association will lead to practice ownership, in whole or in part, by way of a solo group format, co-ownership arrangement or complete acquisition.

In order to attain practice ownership through an association, make the effort to locate and associate with a practice which you desire to own. While locating the right practice is not an easy task, the more effort you put into the process, the better your chances of success.

View the associate period as an opportunity to prove yourself. While there are generally no promises of practice ownership during the associate period, there can and should be a detailed discussion, prior to employment, of the potential for future ownership. This assumes that the associate period will be successful. The potential for ownership discussion should be memorialized through a non-binding letter, outlining the general parameters, terms and conditions of both the associate arrangement and future ownership in the practice. By utilizing this format, the practice owner(s) and you should minimize the potential for misunderstandings relative to the associate period and future ownership. It should be noted that unless the practice owner(s) invites you to become an owner after proving yourself during the associate period, there would not be an opportunity for practice ownership.

Prior to commencing the associate period, you should be requested to review and sign an associate employment agreement. The employment agreement would include provisions relating to compensation and benefits, non-competition/non-disclosure, duties and responsibilities, vacations and other time-off and termination of employment.
We are seeing a drastic increase in corporate practices with multiple locations. Unless you are willing to accept the long-term proposition of working for someone else, make sure that your restrictive covenant is for the location only where you primarily work. If you plan to purchase, acquire a practice or find a practice to later associate with, let the employer know that you will probably reduce your practice time, but may still desire to work for the corporate practice on a reduced schedule. Make sure that your notice period for termination is workable for you, e.g., 30 or 60 days. Be very cautious of employment contracts that make it difficult for you to terminate. Finally, ensure that your employment agreement provides that you will continue to be paid any commissions after you leave, with a written monthly accounting.

As an associate, you are an employee, not an independent contractor. The IRS and states do not offer you or the employer a choice on worker classification. Where the practice bills the patients, pays the operating expenses, pays and schedules you and where you are subject to a restrictive covenant, you are an employee and not and contractor.\(^1\) Misclassification is costly for you and the employer.

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\(^1\) The Practical Tax Lawyer, Summer 2010, William P. Prescott, E.M.B.A., J.D., "Worker Classification Issues in Professional Practices".
In narrative form, list your goals and career objectives in terms of the categories below:

I. Patient Demographics;

II. Method of Payment for Your Services;

III. Procedural Mix;

IV. Practice Location;

V. Location of Residence;

VI. Practice Form;

VII. Mission Statement;

VIII. Continuing Education Statement;

IX. Statement of Commitment to Learning the Business of Dentistry/Specialty;

X. Practice Characteristics;

XI. Statement of Community Involvement;

XII. Statement of Personal and Family Goals;

XIII. Other Categories Which You Deem Relevant; and

XIV. Available Opportunities.
## PRACTICE OPTION REPORT

### PRACTICE OPTION MATRIX/QUANTITATIVE SEGMENT

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<th>Establish Practice</th>
<th>Acquire Practice</th>
<th>Acquire Portion of Practice/Practice</th>
<th>Solo Group Arrangement</th>
<th>Associate</th>
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<td>13. Net Through Second Year</td>
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<td>14. Net Through Any Specified Number of Years</td>
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Chapter 4

THE IMPORTANCE OF THE PRACTICE VALUATION

The IRS has defined fair market value as the price at which property would change hands between a willing purchaser and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. In order to meet the IRS definition of fair market value, the purchaser and seller would be considered to be dealing at arm's length, in a market based upon negotiation, supply and demand.

Seller's Perspective

From the selling doctor's perspective, he or she expects to be paid the purchase price and be succeeded by a worthy incoming doctor(s) to continue treatment of patients and retain referral sources in a specialty practice.

Incoming Doctor's Perspective

The incoming or purchasing doctor wants to have confidence that he or she is actually receiving the practice and its patient base and/or referral sources. The purchasing doctor wants "patients in the chair" to ensure that any acquired goodwill or intangible value has been transferred.

Are Practice Values Declining?

Not yet, but soon! First, dental schools and specialty programs are graduating fewer doctors than in the past. Second, an increasing number of doctors are retiring. Third, the population is increasing. Fourth, doctors want to choose where they practice geographically and do not desire to live in certain areas. For example, it is very difficult to find candidates who desire to practice in rural settings in any state. Finally, due to the supply and demand for dentists and specialty practitioners, the trend of doctors establishing their own practices is increasing. At this point, the incoming doctor has additional options of establishing a practice or becoming an associate in a busy practice rather than buying the practice of a retiring doctor; particularly if the requested purchase price is overly high. For these reasons, practice values should decline. However, quality practices with healthy profitability in desirable areas tend to retain value. And, practices with uncontrolled overhead, staffing problems, inadequate scheduling policies, poor collections and ineffective management systems in undesirable geographical areas are drastically declining in value. What's more, the doctors who own these practices have insufficient profitability to fund their retirement plans. These are the practices which need drastic operational changes and management training. These practices will be difficult to sell.

Verification Analysis

Irrespective of the valuation method used in appraising the practice, your accountant should complete a "verification analysis". This analysis should consist of four categories. That
is, based upon what you project as the annual collections of the practice to be with you as the owner(s), you must: (a) earn a living comparable to an "associate" doctor; (b) pay the operating and capital expenses of the practice which you incur; and (c) pay the lender(s) the purchase price for the acquired practice; and (d) accomplish this within a measured time period, e.g., five or seven years. This is the basis of the verification analysis which determines whether the purchase price is realistic, irrespective of the valuation method used.

Although your projected collections may be identical to the historical collection rate of the selling doctor(s), you should calculate and determine the percentage of the seller's patient or referral base which will remain with the practice after its acquisition and any growth. In other words, you cannot calculate your compensation and operating expenses without attempting to calculate practice collections or revenue. For example, if it is anticipated that the patient base will decline by 10%, the resulting reduction in collections will be significant to you, as the new owner.

The compensation which a purchasing doctor should earn while paying for a practice should be approximately that which would be earned as an associate dentist/specialist, e.g., 20%-35% of adjusted production, inclusive of hygiene examination fees, as a general dentist; higher for specialists. Another way to pay the associate is 25% of adjusted production, inclusive of hygiene services. Specialists are typically paid between 30%-40% of adjusted production. Both general dentists and specialists are often paid the greater of a "base" rate or the percentage. If you cannot earn an acceptable living while paying for a practice in light of the repayment period for your loan, the purchase price is too high.

To determine the annual operating and capital expenses of the practice which the purchaser will incur, add the selling owner's compensation in all forms, e.g., retirement plan contributions and fringe benefits to the owner. This sum should be subtracted from the annual revenue of the practice.

From the projected level of your compensation needs, you must pay the lender(s) the purchase price. Remember, interest will be included on the repayment amount. Additionally, the tax ramifications must be considered relative to the repayment obligations.

**Importance of Practice Profitability**

It is interesting to note that small percentage changes in owner compensation greatly affect your ability to acquire a practice and pay for it within a measured time period. This is of particular importance in co-ownership because the practice usually must expand or relocate to accommodate the associate.

**Capitalization Rates**

It has been stated that the capitalization rate is equal to the time period for the repayment of the practice purchase price.\(^1\) A reasonable time period to pay the lender(s) for a practice may

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be five or seven years. This time period measures the degree of risk in the operation of the practice as an investment and provides for a capitalization rate of 20%. The lower the capitalization rate, the higher the value and vice-versa. An acquisition with a capitalization rate of 14%, would be paid in approximately seven years and a practice acquisition with a capitalization rate of 25% would be fully paid in four years. When a practice is valued using a capitalization rate, such rate should include both the tangible assets and goodwill.

Because purchasing dentists have been such good borrowers, dental lenders and some banks are increasing repayment periods to 10 years and beyond. The increased prepayment period should be discussed with your CPA and may be acceptable if the prepayment penalty is no longer than one year and you recognize the additional interest that would be paid to the lender. Do not confuse the repayment period to the lender with the calculation of the purchase and selling price, which should be based upon five or seven years. Calculating the purchase price based upon the lender's repayment period will significantly raise the cost of the practice.

**Capital Expenditures**

To the extent that you anticipate, after the acquisition, equipment replacement costs, leasehold improvement costs, a relocation or other capital expenditures of any nature, such expenditures would reduce the available cash flow or owner's compensation to you. The extent that such expenditures would reduce the cash flow to you, the fair market value of the practice would be correspondingly reduced.

**Accounts Receivable**

The accounts receivable of the practice being sold are generally not acquired. Typically, the accounts receivable are collected by your practice and paid to the seller, less an approximate 5% administrative fee. However, there are times when the accounts receivable may be sold at their collectible value in order to provide you with non-lender working capital. Where an associate buys into an existing professional corporation, the associate automatically acquires an interest in the accounts receivable, unless specifically excluded. As a result, the valuation process should account for this. Irrespective of whether the accounts receivable are acquired or not, their disposition will have an impact upon you. The value of accounts receivable after they are purged, would equal the "clean" accounts receivable, multiplied by slightly less than the historical collection rate.

**Reduced Fees**

Generally, the intangible value of the practice being valued would be reduced by the percentage that the reduced fee revenue relate to the total practice revenue. If reduced fees are assigned any intangible or goodwill value, carefully consider the subsequent impact on your future profitability.
Co-ownership Values

In co-ownership, the practice value is usually calculated as if 100% of the practice is being acquired. Thereafter, the percentage of the practice being sold and acquired would be a pro rata percentage. For example, if the fair market value of the practice is $1,200,000 and Dr. Junior acquires a 50% interest, the fair market value acquired would equal $600,000. However, I do not like to include accounts receivable in co-ownership because operational expenses continue to be paid.

Valuation Data

The more complete and accurate the information for which to value the practice or to assess the accuracy of an existing valuation, the easier it will be for you to make an informed decision as to whether to acquire a particular practice. Assuming that it is your intention to acquire a particular practice, it is critical to obtain relevant information relating about the practice in order to determine the purchase price and terms of the acquisition. The information contained in the chart in Figure 4-1 provides the basic information which should be provided by the seller's practice in order to prepare or confirm the valuation report. The information requested to prepare or confirm the practice valuation is a preliminary form of "due diligence" or purchaser homework. Prior to this information being released, you should be asked to sign a confidentiality letter that all information will remain private only to be shared with your advisors and promptly returned to the seller should you not proceed with the purchase.

High and Low Revenue Practices

High and low revenue practices tend to be more difficult to sell than "average" sized practices. This is because it generally takes two or more purchasers to produce the revenues that one or more high revenue producing doctor(s) can generate and low revenue practices cannot provide adequate cash flow for the purchaser to earn a living and meet debt service. To the extent that two or more compatible doctors are needed to acquire a high revenue producing practice, it is more difficult to locate such a combination of compatible talent in the pool of potential purchasers than it is to locate one doctor. For this reason, a lack of marketability discount should be applied to high revenue practices.

One problem with high revenue practices is that they are often burdened with unreasonably high overhead. High overhead definitely impacts value and makes it difficult to sell such a practice or admit an owner. Low revenue practices, on the other hand, often must relocate and additional debt must be incurred.

Seller Beware

Complete Sale

As owner, you spend your life and career building your practice. You are the practice and to you, it's worth a lot. You are ready to sell your practice so you have your practice appraised for what you believe it's worth. What if the practice is overvalued? For the
purchasing doctor, the answer is obvious; the doctor can go broke or possibly be forced to find an additional job to meet outstanding obligations. For the seller? You may not be paid and be forced to return to practice, assuming you can.

Assuming that your practice is sold for cash, you have little to worry about if overvalued. Assuming that a purchaser bought an overvalued practice for cash, the purchaser has lots to worry about.

Assume that you engage a broker to sell your practice and the broker completes the appraisal and overvalues the purchase price. The broker has found a potential purchaser who agrees to acquire your overvalued practice, but you are required to finance a substantial portion of the sale. Maybe the purchaser is told that both the practice and location have great potential; that fees can, on the average, be raised 10%; that you don't do endodontic procedures and the purchaser will; and that you only work a few days per week and that the purchaser will work 5-1/2 days; and that you can remain in the practice two days per week indefinitely because you have no plan to spend your time outside of dentistry after retirement. Sounds great? Maybe. But you are asked to finance some portion of the sale price. This creates a substantial potential for default by a soon-to-be discouraged doctor who recently purchased your practice. You don't get the full purchase price and the incoming doctor fails. A lose-lose situation.

How do you protect yourself? Make sure that the contract you sign with any broker specifically provides for cash in full at closing.

If a practice broker's fee is based upon the sales price of the practice, it's obvious that the broker is representing the selling doctor. Therefore, it is imperative for the purchasing doctor to have an independent valuation of the practice completed, as well as the verification analysis of what the cash flow will be for the period of time when the practice is being paid for. Who does this analysis? The purchaser's licensed CPA; the CPA who will be retained by the purchasing doctor after the sale. Please note that there are many very good practice brokers who have your interests as a first priority and who maintain extremely high standards. The broker litmus test; require cash in full at closing.

The marketplace is changing due primarily to supply and demand for doctors. Yet, it is easier to establish a practice than any time since the late 1970's, assuming that the new practitioner can obtain 30 to 40 new patients per month. As a result, practice values should now be in decline, but are not. Doctors who are planning for their succession should: (a) plan for future economic needs by proper retirement plan funding; and (b) commit themselves to the management training necessary to attain and maintain consistently healthy profitability. It is the healthy and profitable practices which will best retain value and act as a vehicle to allow the owner the freedom to retire.
A. **Compatibility of Purchaser and Seller**

1. Contrast seller(s) practice mission and philosophy to yours;
2. Contrast seller(s) personal values and work ethic to yours; and
3. Assess seller(s) reason for departure from active practice.

B. **Financial Information**

1. Federal income tax returns of the practice for the lesser of the last five fiscal years or the number of years in practice;
2. Financial statements and balance sheets (assuming that they are prepared for the practice) for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date; and
3. An aged trial balance of all practice accounts receivable and the historical practice collection records for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date.

C. **Practice Facility**

1. A floor plan of the practice facility;
2. An itemized list and the fair market value of all dental equipment being acquired by treatment room, plus darkroom, utility room, sterilization area, x-ray area and laboratory;
3. An itemized list and the fair market value of all office equipment and furniture being acquired;
4. An itemized list and the fair market value of all tangible assets, personal and other items located in the practice facility not being acquired;
5. An itemized list and the fair market value of all tangible assets (dental equipment, office equipment, and furniture) leased by the practice or located in the practice facility to which the practice does not hold clear title; and
6. Maintenance records for all dental and office equipment from the date of purchase through the current date.
D. **Lease and Real Estate**

1. A copy of the current lease, any renewal amendments and any document evidencing recording of the lease; and

2. Copies of any deed, documents and/or agreements relating to the practice owner's (or family members') ownership of the practice real estate.

E. **Operations**

1. The number of active patients (patients treated in the past twenty-four consecutive months), as well as inactive patients (those patients not having any dental services rendered within the last twenty-four consecutive months);

2. A summary of the number of new patients in each consecutive month for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

3. A summary of the current number of patients (and percentage of the practice) in recall, if applicable;

4. A current fee schedule and a summary of fee increases for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

5. A specific list of those procedures performed by the practice and those referred to specialists, if applicable; and

6. Provide your written evaluation of the area demand and potential for economic growth for a dentist/specialist in the geographical area where you intend to practice.

F. **Employment Relations and Benefits**

1. Census of all employees of the practice, the hours worked, compensation levels, positions, responsibilities and dates of hire (including former employees) for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date; and

2. Provide copies of any employee handbooks, job descriptions and/or other publications distributed to employees of the practice.
Chapter 5

CALCULATING PRACTICE VALUE IN A REAL STRANGE MARKET

The valuation methods reviewed herein include: (a) summation of assets; (b) capitalization of earnings; (c) capitalization of excess earnings; (d) multiple or percentage of gross revenues; and (f) values of similar practices. Excess earnings and discounted future earnings are described, but examples have not been included.

The valuations herein contemplate a complete sale and purchase, although partial sale and acquisitions are usually based upon a prorata percentage of the practice acquired. For example, if the doctor acquires a 50% interest, the purchase price of 100% of the practice is multiplied by 50%.

Summation of Assets

Under the asset approach, the fair market value of the asset categories are determined. The collective sum of those values represents the fair market value of the practice. Those asset categories are as follows:

Dental Equipment and Cabinetry

Dental equipment and cabinetry may be determined by appraisal through your dental dealer. Generally, you will find that dental dealers charge a modest amount. In fact, I never did charge for this service as a dental dealer because it created goodwill with the doctor who would probably purchase dental equipment in the future. The fair market value of the dental equipment should be its value "in place" and functioning, rather than the price that the dental dealer could receive for the equipment sold as individual items; not in place although operational. For example, a ten year old "over the chair" unit is worth more in place and operational condition because a purchasing doctor can use it to treat patients. This same unit may be worthless if it were stored in a dental dealer's warehouse for resale with water lines corroding.

Another method of valuing dental equipment is to use a straight-line depreciation over a given period of years. For example, if you are using a useful life of twelve to fifteen years, then the equipment is depreciated by 1/12 or 1/15 each year. The "in place" value of dental equipment and cabinetry generally maintains a 15% to 35% salvage value, often 20%. Therefore, an equipment item should approximately maintain a value of at least 20% of its original cost, so long as it is in place, functioning and usable.

An alternative approach to valuing dental equipment, office equipment, furniture and cabinetry is through the use of the balance sheet, the "Balance Sheet Approach". The balance sheet should indicate the net book value of the equipment; the original cost, less depreciation and any amount owing for the equipment. Add back to the net book value 25% to 40% of the depreciation already taken. Provided that the equipment is in operational condition and is not
required to be replaced immediately, 25% of the original cost could be used as a base value. The Balance Sheet Approach is described in Figure 5-1 and also includes the categories of dental equipment, office equipment, furniture and technology.

Additional considerations are appropriate to consider with regard to the fair market value of dental equipment. First, technology rapidly changes and established doctors may not keep pace. As a result, it may be necessary for the incoming doctor to update the facility and pay the associated costs which impact cash flow. Where equipment must be replaced immediately, it would not have any fair market value, irrespective of salvage value. In fact, the value of the practice would be reduced by the value of the equipment to be replaced. Likewise, if certain equipment needed to operate the practice is not in place, i.e., sterilization unit or vacuum system, such equipment would be required to be purchased and its cost would negatively and directly affect the value of the practice.

The fair market value of dental equipment will be less for a potential purchaser if the selling doctor is right-handed and purchaser left-handed or vice versa. Not only will the equipment be of less value to the purchaser, but the cabinetry design, door entries, and assistant's system will also be incorrectly placed. Left hand selling doctors may need to plan for right successors.

It may be appropriate to review all repair bills for the past three to five years and year-to-date for all dental equipment. Certain manufacturers have ceased business operations in recent years and some items and lines of equipment have been discontinued. As a result, it could be very difficult, if not impossible, to obtain parts when needed. Additionally, certain equipment items have had extremely high maintenance costs and may have never performed as intended. These items would not retain the same value as equipment items that do perform as intended. Every practice has at least one equipment item which is a continuing problem. Effective dialogue with the selling doctor should serve to disclose these mechanical problems. Further, the service technician with whom you plan to work with from your dental equipment and supply company should perform a maintenance check on the equipment you plan to purchase before you acquire the practice.

Some doctors maintain equipment better than others and in accordance with manufacturer's standards. Alternatively, some doctors use equipment without regard for its maintenance. Therefore, the fair market value of such equipment should reflect the maintenance and use.

Treatment room layout can have an effect upon the fair market value of the equipment. For example, if an intraoral x-ray does not reach all positions properly, the x-ray has less value than an x-ray which is placed properly.

If all treatment rooms have identical equipment and operating systems are standardized, then any procedure can be performed in any room, including the room in which the hygienist(s) works. Additionally, the more functional the overall facility design, the more efficient you can
be. As a result, the in-place value of the equipment in a well designed facility will be greater than in one which is poorly designed.

**Office Equipment and Technology**

As to office equipment and technology, it may be easier to either: (a) add a percentage of the depreciation taken to the net book value utilizing a minimum base value; or (b) use a straight-line depreciation over a given period of years. Twelve to fifteen years for office equipment would be an appropriate depreciation period with not less than a 20% minimal salvage value. However, this generalization may be greatly impacted by changing technology. Generally, neither you nor the dental dealer valuing the dental equipment will have a working knowledge of the fair market value of the various items of office equipment which is an appropriate reason to value the office equipment from the balance sheet for the practice. Computer and other technological systems that retain less value than other office and dental equipment.

**Dental Supplies**

For dental supplies, it would be reasonable to value three or four months of supplies on hand. As the last twelve months are more reflective of current supplies than prior years, the last calendar year, depending upon the valuation date, or the most recent twelve months may be utilized to obtain the value of dental supplies. The twelve month period is then divided by four. However, be cautious of significant year end supply purchases.

As to taking an actual inventory, such a calculation is usually irrelevant to the purchaser, as the purchaser will generally not use the same impression materials, filling materials, instruments, etc. as the seller. Therefore, the actual fair market value of supplies to the seller is not the fair market value to the potential purchaser. Additionally, pricing an actual inventory is very time consuming. In the early 1970's as a dental supply salesman, I prepared and priced, without a computer, several supply inventories. As I recall, it generally took about forty hours to complete and the fair market value of the supplies was approximately the same each time. The fair market value of the inventory value would generally approximate a three or four months' supply, irrespective of the fact that the purchaser will probably not use the same supplies as the seller. Therefore, a three or four month value, in my view, may be appropriate. Remember, some practices keep more inventory on hand than others and generalities do not consider the specific practice.

**Office Supplies**

It is reasonable to obtain the value of office supplies in the identical manner as the value of dental supplies, the total of office supplies for the most recent twelve months, divided by four or six, equaling a three or two months' supply on hand. The possible rationale behind two months, as opposed to a three month or higher value, is due to the possible uniqueness of office supplies, e.g., stationery, envelopes, etc., with the name of the seller. Additionally, the purchaser probably will not utilize the same business systems as the seller, unless a partial interest in the
practice is purchased. However, where an associate buy-in is contemplated, this issue may be minimized.

**Accounts Receivable**

Generally, accounts receivable are not sold and are collected by the purchaser on behalf of the seller, less an administrative, e.g., 5%, for a period of six months from the date of closing for the sale and acquisition. Therefore, the value of the accounts receivable would not be includable in the fair market value of the practice. The rationale here is the seller would have to discount the value of the accounts receivable to the purchaser, as opposed to collecting his or her customary collection percentage.

Sometimes the purchaser will acquire the accounts receivable in an effort not to borrow the funds to maintain uninterrupted practice operations. In some cases, the purchase of the accounts receivables can resolve this cash flow problem. In the event that the purchase acquires the accounts receivable, the purchase calculation may be to determine the historical "collectible" collection percentage on a yearly basis, e.g., 95%. Collectible accounts receivable would be those receivables which are reasonably collectible, e.g., 120 days old or less. For example, if the practice collects 95% of billed and uncollected accounts receivable on the yearly basis, the 5% uncollectible accounts receivable should be periodically written off. If the 5% of uncollectible accounts receivable built up each consecutive year without being written off, the purchaser would be acquiring uncollectible accounts receivable. Another method of determining the collectible accounts receivable would be to age the monthly receivable amounts and multiply the amounts by a declining percentage for each month out to 90 or 120 days. For example, accounts receivable 30 days old or less would be multiplied by 95%; 60-30 days would be multiplied by 85%; and 90-60 days would be specifically reviewed for collectability and multiplied by 60%. The decision would then be made whether to purchase any accounts receivable 90-120 or more than 120 days old. In acquiring accounts receivable, completing the due diligence or purchase homework and in determining the overall value of the practice, the accounts receivable collection percentage, the length of time when payments are received, the collection and billing policies of the practice and the methods of payment; third party insurance or out of pocket payment by the patient or managed care contract should be considered.

Accounts receivable are not generally part of the practice sale. The collection ratios, collection policies and method of payment play a significant part in the overall determination of fair market value for the intangible assets of that practice in questions.

**Advance Payments in Orthodontic Practices**

In orthodontic practices, it is not uncommon for orthodontic cases being paid in full, in advance. Typically, the purchase price for the practice would be reduced by the advance payments and offset by the actual accounts receivable for work already completed.
Lease

Some appraisers attempt to place a value on a favorable lease or a negative value on an unfavorable lease, which would be assigned to a purchaser as part of the practice transition. While a favorable lease may be of value to a seller, the value of the practice should not be increased to the purchaser. Rather, a favorable or unfavorable lease would add or detract from the intangible asset value. Additionally, an unfavorable lease or a practice facility with too much or too little square footage can detract from the seller's ability to sell the practice. If a seller has attempted to sell his or her practice, the ability to assign the lease or obtain a new lease should be expected by the buyer. Assigning a lease to a purchaser does not usually present a problem, although there are exceptions. This matter should be considered in the drafting of the lease for the seller prior to the proposed practice sale. Most landlords require the seller to remain secondarily liable in the event of a default by the buyer for the remainder of the seller's previous lease term. This issue should be considered with the landlord for the lease term or option period prior to the practice sale.

Leasehold Improvements

Such costs are a trade-off between what an practice owner has previously spent on such costs, not the landlord, and the amount of money which a buyer would spend if he or she established a practice. Unfortunately, dental practices are required to pay for specific plumbing, electrical and carpentry costs related to dental equipment and cabinetry, which certain other professional practices often do not require. These costs can be substantial. As a result, sellers sometimes feel justified in placing a value on these costs as an asset and which a purchaser will avoid by purchasing a practice, as opposed to establishing a practice. Generally, I do not place a value on leasehold improvements because the seller does not own them.

If I were to place value on leasehold improvements, the book value provided in the seller's Federal tax returns or financial statements for the practice may be appropriate. A twenty-year straight-line depreciation, with a 20% salvage value which is premised upon the seller's original costs may be an alternative method, but that seems high. Some appraisers also use 10 to 15 years as a time period for depreciation. Twenty years may be appropriate for dental practices, as leasehold improvements should be usable for such a period of time. However, certain factors have an effect on whether the leasehold improvements will remain an asset for twenty years. For example, to the extent that it is necessary to expand, redesign or reequip the practice facility, the purchaser will incur additional leasehold improvement costs. Those costs should be considered in the value of leasehold improvements to the seller or possibly subtracted from the fair market value of the practice. Finally, if the seller owns the building, shouldn't the leasehold improvement costs be included in the value of the real estate?

Intangible Assets

The value of intangible assets can be thought of as the future cash flow attributable to a purchaser(s) operating the practice in place of the seller(s). This value is generally based upon a number of subjective factors, all of which are rated differently by various appraisers. Figure 5-2
provides thirty factors, many of which will ultimately impact the two major factors of annual gross revenues and doctor compensation in all forms. The factors are all weighted differently, depending on the characteristics of the practice being appraised or valued. Although defining intangible asset value is truly subjective, some appraisers have attempted to develop rating systems of certain criteria affecting intangible asset value and will adjust upward or downward depending upon the weight of the factor, e.g., percentage of the practice in recall. However, a particular rating system will affect each practice being valued differently. As an example, in one practice location may be more important than in another.

Where intangible value is based upon annual gross revenues, the multiplier has traditionally been between .2 and .5. The Goodwill Registry's actual data found the statistical mean goodwill at 46.35% of one year's collections. In reality, I believe that these rates are low as the market exists in 2008. Where intangible asset value is based upon annual doctor compensation in all forms, the multiplier has traditionally been between 1.0 and 1.5. Other authorities have used 50% to 80% of total earnings available to the doctor. The rating criteria used by the appraiser, like those described in Figure 5-2, will determine the multiplier used. Of all rating criteria, I believe that the most important are annual revenues of the practice and doctor compensation in all forms, e.g., compensation, bonuses, net profits, automobile expense, portion of the retirement plan contributions attributable to the doctors, statutory fringe benefits to the doctors like health insurance premiums, some continuing education costs, travel expense and entertainment expense. It is interesting to note that where intangible asset value is based upon owner compensation in all forms and assuming that average practice profitability is roughly 40% of annual gross revenues, then the 1.0 times doctor compensation in all forms formula converts to 40% of annual revenue at one times doctor compensation on the average. 1.5 times doctor compensation equates to approximately 60% of annual revenues, which, unfortunately, is what I see in the market in 2012, except for the destination locations. Further, we see rates much higher than this. Therefore, the traditional limits of intangible asset or goodwill value equate to 20% to 60% of annual gross revenues. This range is extremely broad with 1.25 times doctor compensation being very common. However, this multiple must take into consideration the practice characteristics in Figure 5-2, must notably yearly revenue and practice profitability.

Let us assume that in Figure 5-1 that the selling practice owner requests of the appraisal equates to 65% of one year's gross revenues as the purchase price and we already have determined that the fair market value of the tangible assets is $130,000. If yearly revenue is $1,000,000 and tangible assets are $130,000, the goodwill of the practice or the selling doctor, as the case may be, is $500,000 or approximately 50% of one year's revenue. In other words, the

total purchase price in this example, including any personal goodwill of the selling owner, is 65% of annual revenue of $1,000,000.

**Verification Analysis**

Figures 5-3 and 5-4 determine at what price a practice can afford to purchase itself.\(^5\) Note that a 5% interest rate was used in these Figures. Assuming that a purchaser's only source of income is the practice being purchased, the purchaser should pay no more for the practice than the cash flow for the practice can support. Additionally, the purchaser needs a yearly compensation level to live comfortably while paying for the practice, but typically not at the compensation level of prior owner(s). In determining the compensation level for a purchaser while paying for a practice purchase, the purchaser should review the compensation that he or she could earn as an associate, realizing that the practice being purchased will eventually be paid for. The question is then how long is the repayment period?

The verification analysis can be thought of as a "check" against any valuation method to determine the affordability over a predetermined payback period. As indicated in Figure 5-3, the Verification Analysis for the asset summation method of valuation considered working capital needs, renovation/equipment replacement requirements, as well as the loan for the payment of the practice. Assuming no decrease in yearly revenue, the purchaser will earn 27.11% of revenue as compensation in all forms. Not bad considering that hygiene services are included in this amount.

In the example provided, the purchaser has 15 Considerations to analyze. In particular, item 9 of the Considerations questions the economic stability of the practice if revenue, patients and/or patient referral sources decrease? Note that the second column of Figure 5-3 shows the effect of a 10% decrease in annual revenue. If revenue decreases by 10%, the purchaser earns 20.78% of revenue as compensation in all forms and would likely consider another opportunity. The only operating expense decreases in this example are dental supplies and laboratory costs at 6% and 10%, respectively.

In the event that there would be no remodeling and equipment replacement costs or working capital needs, the yearly owner compensation in all forms is clearly higher and is helpful. However, if there is no operating capital is borrowed, then the accounts receivable would have to be purchased and paid for to maintain practice operations. And how often will capital expenditures in a newly purchased practice be the de minimis or non-existent? Not often because all dentists practice differently.

If no working capital is needed and no remodeling/equipment replacement costs are incurred until the incoming doctor establishes a consistent cash flow, the purchaser will earn 28.98% of revenue in line 11 of Figure 5-3, which is more favorable than 27.11%; 28.86%, assuming a 10% revenue decrease.

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The summation of assets method of valuation adds all tangible asset categories of the practice being sold and acquired together, as well as the intangible assets being sold by the practice or departing practice owner to the purchaser.

After the asset values are totaled, the verification analysis should be completed by the CPA for the purchaser to determine what the likely cash flow or compensation will be while paying the operating expenses, the purchase price to the lender(s), all in a measured time period.

**Capitalization of Earnings**

The term "capitalization rate" can be thought of as the percentage by which a constant income stream is divided in order to obtain the value of the business on the basis of an assumed rate of return. The income stream represents the annual sum available from gross revenues after the payment of operating expenses for the purchaser, the purchase price to the lender(s) and an "agreed" compensation amount to the purchaser. Provided that the stream of income being capitalized is constant, then the multiple is the reciprocal of the capitalization rate. This sum would also be exclusive of interest or the time value of money.

Capitalization rates are determined by the market and when expressed as a percentage return on an expected stream of income, the capitalization rate represents the rate of return available in the market on investments expected to produce similar streams of income. Capitalization rates are based upon: (a) the nature of the business; (b) the risk involved; and (c) stability or irregularity of earnings. As a starting point for determining an appropriate capitalization rate for dental or dental specialty practices, it is appropriate to consider determining the rate of return for U.S. Treasury bills and long-term U.S. Government bonds, a relatively safe investment, and then adding back points to compensate for the risk and illiquidity of the investment in the practice. The capitalization rate would be adjusted upward or downward according to various factors which impact practice value, e.g., the factors in Figure 5-2. A low capitalization rate yields a high practice value and vice versa. For example, a 20% capitalization rate would be a multiple of 5. This is represents a much lower purchase price than a 14.28% capitalization rate or a seven year repayment period. A 25% capitalization rate would be a multiple of 4 or a four year repayment period. Note that the capitalization of the earnings is typically exclusive of interest. Therefore: (a) slight increases or decreases in the capitalization rate or repayment period create substantial variations in practice value; (b) practice

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8 Revenue Ruling 59-60, Section 6.


profitability directly determines the amount available to be capitalized; and (c) new owner compensation and benefit levels also directly determine the amount available to capitalize over a measured time period.

Figure 5-4 provides for purchaser compensation of 25% of $1,000,000 in annual revenue or $250,000. Again, this includes hygiene revenue. It should be recognized that it may take two purchasers to produce at this level, which has the effect of decreasing the candidate pool. In the capitalization of earnings method of valuation, tangible assets and goodwill are included in the sum available to be capitalized. In line 8, there is $131,344 available, exclusive of interest, to pay for the practice over five or seven years. Decrease revenues by 10% in line 8 with the same 25% of purchaser compensation and the purchase price is significantly reduced.

What was not considered regarding to the determination of capitalization rates in Revenue Ruling 59-60, Section 6, was the ability of a business owner, the dentist, to successfully establish his or her own business or practice. Different doctors have varying abilities and personalities which assist or hinder them from developing a patient or referral base in the start-up mode. Therefore, the opportunity to purchase a practice may be more valuable for one doctor without the ability to develop a patient or referral base, as opposed to another, irrespective of technical and clinical skills.

For example, one general dentist has developed a practice. This doctor started on a second floor in a location without an elevator, and had to work at other practices initially. Overhead was kept at a minimum. The doctor operated out of one treatment room. The office was nicely decorated with many photographs of friends and patients, along with other personal items. This doctor has always enjoyed the profession of dentistry and radiates the enjoyment of the profession to everyone whom the doctor comes in contact with. The doctor's practice is now well established, and several years later, the doctor has moved into the doctor's own building to accommodate growth. The doctor's attitude and love for dentistry attracts patients and has created a successful practice. Because this doctor had the desire and learned the skills to establish a practice, it would not have been advisable to purchase a practice. This dentist did not need or desire to purchase a practice.

On the other hand, a dentist walked away from a very good opportunity to become a co-owner. Instead, the dentist established a practice and struggled to get a sufficient number of patients in the chairs.

Multiple of Gross Revenues

Although the multiple of revenues method of valuing a practice is relatively simple, this method should not be used alone, as it does not account for the particular characteristics, positive or negative, of the practice being valued. Where a multiple of gross revenues can be useful is where the appraiser is attempting to assess the current range or trend of values for dental or dental specialty practices, then adjusting the average of values as a percentage of one year's
gross revenues, e.g., 40% - 65%\(^{10}\), based upon the uniqueness, profitability and revenues of the particular practice.

An example of the multiple of gross revenues approach is set forth on Figure 5-5 and the dental practices in this example averaged a multiple of gross revenues of 64%.

**Similar Practices**

The value of similar practices is a valuation approach which should be valid if there were a large enough number of comparable transactions involving practices with similar characteristics, e.g., one doctor, three treatment rooms, which were sold upon similar terms and conditions. The problem here is that no two practices are identical and the terms and conditions of each practice sale are different. For example, two practices with gross revenues of $1,000,000 will each have varying profit percentages. One practice may yield owner compensation in all forms of 40% and the other at 35%. These practices should have different selling prices even though their gross revenues are identical. In addition, one practice may have to replace equipment and relocate in the foreseeable future. This will impact the selling price. The value of similar practices can be useful if proper information is available to document the terms and conditions of other practices sold in a similar geographic area.

Figure 5-6 provides a recap of practice values. It is common to value a particular practice using more than one method, although not necessary. Often, all methods used are averaged to arrive at the determination of fair market value for the practice being appraised. However, if the verification analysis does not support the assessed fair market value, it does not matter what method is used if the economics of the sale and acquisition do not provide for a win/win transaction between the parties.

What I find interesting is Figure 5-7. This example shows that small variances in profitability have a significant impact upon the value. In Figure 5-7, the practice has $1,000,000 in yearly collections, owner compensation of 27.5% of collections and profit of 38%, 40% and 42%. If we utilize the 20% capitalization rate on the available profit to pay for the practice, the results differ significantly.

**Methods That Don't Work Well For Dentistry**

**Excess Earnings**

The excess earnings method or "formula" approach to valuing a practice is premised upon the capitalization of earnings in order to determine the value of intangible assets and is described in Revenue Ruling 68-609. The steps in this method are as follows\(^{11}\):


\(^{11}\) Revenue Ruling, 68-609.

1. The fair market value of the "hard" or tangible assets should be determined;

2. Determine the annual practice earnings, averaged over the past five years, after deducting owner compensation;

3. An appropriate rate of return should be ascertained, 8-10%\(^\text{12}\), on the value of the intangible assets as a return on investment;

4. Subtract the return on tangible assets from the annual practice earnings;

5. The annual practice earnings, less the return on tangible assets should be capitalized and the resultant amount is the goodwill or intangible asset value of the practice; and

6. The tangible assets and intangible assets are added and the sum is the value of the practice.

Although the formula approach has been considered valid case law, this Ruling states that the formula approach should not be used if there is better evidence available to determine the intangible asset value. In the second edition of this work, I included an example of this method. However, I have not included such herein because I do not believe this to be one of the better methods of valuing a dental or dental special practice. It is worth mentioning though, because some appraisers use this method of appraisal routinely.

**Discounted Future Earnings**

Some appraisers use the discounted future earnings method to value practices. This method is based upon the future benefits, earnings, which will be produced by the practice in future years, discounted back to a present value at some discount rate.\(^\text{13}\) This method was not historically used in the valuation of dental and dental specialty practices but is now becoming more popular, irrespective that: (a) future profits would be based upon the purchaser's efforts as the new owner of the practice, as opposed to past efforts of the seller; and (b) it can be difficult to reliably predict future earnings in a changing market. Alternatively, capitalization rates reflect the historical profitability or earnings of the practice.\(^\text{14}\)

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\(^{12}\) Revenue Ruling, 68-609.


Required Information

The more complete and accurate the information for which to value the practice, the more effective the practice valuation. The items needed are as follows:

1. Federal income tax returns of the practice for the past five years;
2. Financial statements (if they are provided for the particular practice) for the past five years and year to date;
3. A copy of the current lease and any renewal amendments;
4. A floor plan of the practice facility;
5. A listing of all dental equipment by room, plus darkroom, utility room, sterilization area, x-ray area and laboratory;
6. A listing of all office equipment and technology;
7. Maintenance records for all dental and office equipment for the last five calendar years and year to date;
8. An aged trial balance of all accounts receivables;
9. An accurate description of treatment procedures performed and those referred out.
10. A current fee schedule and a summary of fee increases over the last five years, as well as the corresponding amounts;
11. The number of active patients (patients treated in the last 18 months), as well as inactive patients;
12. A summary of the number of new patients per month over the last five years and year to date; and
13. A list of all employees, hours worked, compensation levels and dates of hire, including former employees over the last five years and year to date.

Under normal circumstances, it is difficult to obtain all information requested in valuing a particular practice. If some requested information is unavailable, the appraiser must make certain assumptions based upon the information available, while noting the information on which the appraisal is based. However, certain information is crucial, such as Federal tax returns and accurate year-to-date financial information.
Note that photographs of the practice facility are helpful, as well as videos, for the reason that photographs and videos force the seller to understand that someone else will be looking at the layout and appearance of the premises. A visit to the practice is clearly the best approach, but needs to be weighed against the additional cost of the appraisal, which should be budgeted in advance.

Of all valuation methods described herein, the one common factor is that the determination of fair market value will be subjective, but market driven.

**Five Important Rulings**

1. **Revenue Ruling 59-60.**

   Revenue Ruling 59-60 set forth the relevant criteria for determining fair market value of a closely held business, a business with a relatively small number of owners or practice for estate and gift tax purposes. The factors which should be considered in the determination of fair market value are as follows:

   (a) The nature and history of the business from its inception;

   (b) The economic outlook in general and the condition and outlook of the specific industry in general;

   (c) The book value of the stock and the financial condition of the business;

   (d) The earnings capacity of the business;

   (e) The dividend paying capacity;

   (f) Whether or not the business has goodwill or intangible asset value;

   (g) Sales of the stock and the size of the block to be valued; and

   (h) The market price of stocks of corporations engaged in the same or a similar businesses.

   Revenue Ruling 59-60 also went on to indicate that fair market value depends upon the circumstances of each case and is not an exact science. It changes with general economic conditions, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. In many instances, the best measure of fair market value may be the price of similar practices.
Additionally, profit and loss statements should be obtained for five or more years. Earnings are one of the most important criteria of value in cases where products and services are sold to the public, whereas the value of the assets is the most important criteria in valuing closely held investment or real estate holding companies.

As to capitalization rates, there is no ready or simple solution and wide variations will be found for companies within the same industry. Additionally, the capitalization rate will fluctuate from year to year depending upon general economic conditions. The factors which should be considered in determining the capitalization rate are: (a) the nature of the business; (b) the risk involved; and (c) the stability or irregularity of the earnings.

Because valuations cannot be made on the basis of a prescribed formula, there is no means to weigh the various applicable factors of a particular case in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors or methods of valuations, for example, book value, capitalized earnings and capitalized dividends, and basing the valuation on such a result. Such a process excludes active consideration of other pertinent factors and the end result cannot be supported by a realistic application of the significant facts, except by mere chance.

As to the fair market value of buy-sell agreements, the stated purchase price of the stock is a factor to be considered with other relevant factors, including fair market value for estate tax purposes. It is always necessary to consider the relationship between the parties, the number of shares held and other material facts to determine whether the buy-sell agreement represents a bona fide business arrangement or is a device to pass the decedent's shares to the natural objects of his or her bounty for less than adequate and full consideration for money.

2. **Revenue Ruling 65-192.**

Revenue Ruling 65-192 expanded Revenue Ruling 59-60 and stated that the methods and factors outlined in Revenue Ruling 59-60 for use in estate and gift tax purposes applied equally to valuations for income and other tax purposes, and were also useful in determining the fair market value for business interests for any type, and the intangible assets, for all tax purposes. Revenue Ruling 65-192 also discussed a capitalization rate of 20% on excess earnings.

3. **Revenue Ruling 65-193.**

Revenue Ruling 65-193 modified Revenue Ruling 59-60 by stating that the instances where it is not possible to make a separate appraisal of the tangible and intangible assets are rare. Revenue Ruling 65-193 suggested that tangible and intangible be valued separately.
4. **Revenue Ruling 68-609.**

Revenue Ruling 68-609 considered the formula or excess earnings approach the determination of fair market value. It further suggested the use of a capitalization rate of 15-20% for intangible assets and an 8-10% rate of return on tangible assets.

5. **Letter Ruling 7905013.**

Letter Ruling 7905013 stated that although the IRS may not disturb the selling price of the entire business, the values of all assets may be reallocated in proportion to their fair market values to reflect the value of goodwill. Therefore, the IRS may reallocate the purchase price of the practice or the owner(s) to reflect goodwill, irrespective of the asset purchase agreement.
Figure 5-1

**SUMMATION OF PRACTICE ASSETS**

I. **Estimated Fair Market Value ("FMV") of Tangible Assets of the Practice**

A. FMV of Dental Equipment, Office Equipment, Furniture and Technology
   1. Balance Sheet Approach — Book Value, Plus 1/3 Accumulated Depreciation
   2. Tangible Asset Appraisal by Dental Equipment Supply Company, but must include office equipment, technology and furniture
   3. 15 years straight line depreciation
   4. 12 years straight line depreciation with de minimis salvage value
   5. Estimated FMV of Dental Equipment, Office Equipment, Furniture and Technology ....................... $ 130,000

B. Leasehold Improvements — Not Owned by Seller

C. Dental Supplies
   1. Dental Supplies @ 6% of $1,000,000 ......................................... $ 60,000
   2. Divided by 12 Months ......................................................... $ 5,000
   3. Monthly Cost of Dental Supplies ......................................... $ 5,000
   4. Three Month Multiple ........................................................... $ 15,000
   5. Estimated FMV of Dental Supplies ........................................... $ 15,000

D. Dental Instruments @ 1/2% of $1,000,000 ............................................ $ 5,000
   1. Estimated FMV of Dental Instruments ....................................... $ 5,000

E. Recap of Tangible Asset Categories

   1. Dental Equipment, Office Equipment, Furniture and Technology $ 130,000
   2. Leasehold Improvements ...................................................... N/A
   3. Dental Supplies ................................................................. $ 15,000
   4. Dental Instruments ............................................................. $ 5,000
   5. Estimated FMV of Tangible Assets of the Practice .................... $ 150,000

II. **Agreed Intangible Asset Value of the Practice and/or Personal Goodwill of Selling Owner at 50% of Practice Revenue of $1,000,000.......................................................... $ 500,000

III. **Estimated FMV of the Practice and/or Personal Goodwill of Selling Owner.............................................. $ 650,000

Figure 5-2

PRACTICE PROFILE FACTORS FOR SELECTION OF CAPITALIZATION AND GOODWILL RATES

1. Annual owner compensation in all forms
2. Annual gross revenues of the practice
3. Operating expenses as a percentage of gross revenues
4. Ability of the seller(s) to transfer the patients and/or referral sources of the practice
5. Number of active patients/referral sources in the practice
6. Number of new patients per month and degree of patient turnover/The number of referral sources in the practice
7. Stability of the practice and surrounding community
8. Competition
9. Fee structure
10. Practice location
11. Demographic characteristics of patients, location, age and income
12. Likelihood that staff, including any associate doctor(s), will remain with the practice after it is sold
13. Availability of lender or seller financing
14. Facility design and square footage
15. Number of treatment rooms, age and condition of dental equipment (right or left handed)
16. Overall appearance, aesthetics and condition of practice facility — Do I need to relocate?
17. Reputation of the practice
18. The number of hours and days worked per year
19. The percentage of patients covered by insurance/managed care/medicaid/other
20. Assignability and term of lease/availability of practice facility, land and building, for purchase

Figure 5-2

21. Ability to expand the practice facility
22. Patient and/or referral source demographics
23. Percentage of collections to gross revenues and age
24. Willingness of seller to assist the purchaser in practice transition
25. Parking and of public transportation availability
26. Effectiveness of recall system
27. Quality of patient records and clinical work performed
28. Quality and experience of staff and degree of turnover
29. Effectiveness of management systems
30. Entity form/completeness of accounting and legal records, as well as any owner agreements, e.g., buy-sell agreement
## Figure 5-3

**VERIFICATION ANALYSIS**

<table>
<thead>
<tr>
<th>No Revenue Decrease</th>
<th>Revenue Decrease of 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>$650,000</td>
<td>$650,000</td>
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<tr>
<td>$110,244</td>
<td>$110,244</td>
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<tr>
<td>$10,176</td>
<td>$10,176</td>
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<tr>
<td>$8,480</td>
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<td>$600,000</td>
<td>$584,000</td>
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<tr>
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<td>$316,000</td>
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<tr>
<td>$128,900</td>
<td>$128,900</td>
</tr>
<tr>
<td>$271,100</td>
<td>$187,100</td>
</tr>
</tbody>
</table>

1. Practice Revenue:
2. Proposed Selling Price of the Practice at 65% of Revenue: (Practice Assets, $150,000; Goodwill, $500,000 or 50% of One Year's Gross Revenue):
3. Less: Payment of Debt Service for Practice (Yearly Payment of Selling Price Over Seven Years @ 5%):
4. Less: Working Capital — Assumes Account Receivables Not Purchased (Yearly Payment of $60,000, Payable Over Seven Years @ 5%):
5. Less: Remodeling and Equipment Replacement Costs (Yearly Payment of $50,000, Payable Over Seven Years @ 5%):
6. Practice Operating Expenses @ 60% of Revenue/10% Lab; 6% Supplies:
7. Adjusted Yearly Owner Compensation @ 40% of Revenue/Reduced Revenues:
   (Owner's net profit from Federal income tax return, plus: (a) automobile expense; (b) existing equipment lease paid off by the selling doctor; (c) retirement plan contribution for the doctor(s); (d) continuing education; (e) travel expense; (f) entertainment expense, less: (a) rental increase after acquisition; (b) wages, part-time employee)
8. Less: Total of Items 3, 4 & 5:
9. Yearly Available Compensation for Purchaser:
10. Ratio of Compensation for Purchaser to Average Revenue where Initial Remodeling, Equipment Costs and Working Capital are Considered ($271,100/$187,100 ÷ $1,000,000/$900,000 = 27.11%/20.78%) *(Includes Hygiene)*: 27.11% 20.78%

Considerations

1. Can you maintain yearly revenues of $1,000,000/$900,000?
2. To what extent will the seller work post-closing and how will this affect your cash flow?
3. Is this an associate buy-in and how is this different from a complete purchase and sale?
4. What is the effect of an increased repayment term for 5 or 7 to 10 or 15 years?
5. Is the anticipated compensation packaged fair, while paying for the practice or practice interest in light of what you can earn as an associate non-owner?
6. Should you acquire another practice in light of your available choices?
7. Should you start your own practice in light of your available choices and given area demographics?
8. Revenue increases — are you selling or acquiring potential?
9. What if revenues, patients and/or referral sources decrease — how does this analysis change?
10. What is the tax and business structure of this complete sale or associate buy-in and what are the implications to you?
11. Is this a fee for service practice? To what extent does the practice participate in reduced fee plans?
12. What procedures are performed in this practice and what procedures are referred to specialists? — What unique services does this practice provide that you do not do, e.g., orthodontics, TMJ, cosmetic services, endodontics, etc.?
13. How much of the goodwill of the practice is corporate and how much is personal to the selling owner?
14. The $500,000 question: How much of the goodwill is transferable?
15. Is the practice located in a "destination" area?
EARNINGS APPROACH —
ANOTHER WAY OF LOOKING AT THIS!

<table>
<thead>
<tr>
<th></th>
<th>No Revenue Decrease</th>
<th>Revenue Decrease of 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Revenue: $1,000,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>2.</td>
<td>Operating Expenses: &lt;$600,000&gt;</td>
<td>&lt;$584,000&gt;</td>
</tr>
<tr>
<td>3.</td>
<td>Less Working Capital Needs (Yearly Payment of $60,000, Payable Over Seven Years @ 5%): &lt;$10,176&gt;</td>
<td>&lt;$10,176&gt;</td>
</tr>
<tr>
<td>4.</td>
<td>Less: Remodeling and Equipment Replacement Costs (Yearly Payment of $50,000, Payable Over Seven Years at 5%)</td>
<td>&lt;$8,480&gt;</td>
</tr>
<tr>
<td>6.</td>
<td>Yearly Available Owner Compensation in All Forms: $381,344</td>
<td>$297,344</td>
</tr>
<tr>
<td>7.</td>
<td>Less, Compensation Requirements for Purchaser @ 25% of Practice Revenue*: &lt;$250,000&gt;</td>
<td>&lt;$225,000&gt;</td>
</tr>
<tr>
<td>8.</td>
<td>Yearly Available Sum to Pay Purchaser Price Exclusive of Interest: $131,344</td>
<td>$72,344</td>
</tr>
<tr>
<td>9.</td>
<td>Above Sum, Multiplied by Five Years, Exclusive of Interest**: $656,720</td>
<td>$361,720</td>
</tr>
<tr>
<td>10.</td>
<td>Above Sum, Multiplied by Seven Years Exclusive of Interest: $919,408</td>
<td>$506,408</td>
</tr>
<tr>
<td>11.</td>
<td>Purchase Price as a Percentage of Gross Revenue — Five Years: $656,720 =65.67%</td>
<td>$361,720 =40.19%</td>
</tr>
<tr>
<td>12.</td>
<td>Purchase Price as a Percentage of Gross Revenue — Seven Years: $919,408 =91.94%</td>
<td>$506,408 =56.27%</td>
</tr>
</tbody>
</table>

* Should compensation be a percentage of revenues or the associate's current yearly compensation, e.g., $120,000? Answer — A percentage because it may require an additional dentist or specialist to produce at this level. Note that the 25% includes hygiene revenue.

** Should interest be included or excluded as the time value of money? If interest is excluded, to what extent will the repayment period be increased?
Figure 5-5

MULTIPLE OF GROSS REVENUE

1. Gross Revenue ........................................................................................................ $ 1,000,000
2. Gross Revenue Multiplier .................................................................................. 64%
3. Practice Value ..................................................................................................... $ 640,000
Figure 5-6

RECAP OF PRACTICE VALUES

1. Summation of Assets ................................................................. $ 650,000
2. Capitalization of Earnings ......................................................... $ 643,810
3. Multiple Gross Revenue ............................................................ $ 640,000
4. Subtotal .................................................................................... $ 1,933,810
5. Averaged ................................................................................... $ \frac{1,933,810}{3}
6. Estimated FMV of the Practice .................................................. $ 644,603
## CAPITALIZATION OF EARNINGS

<table>
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<tr>
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<th>$1,000,000</th>
<th>$1,000,000</th>
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<tr>
<td>Most Recent Year Collections</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Owner Profit Percentage</td>
<td>x 38%</td>
<td>x 40%</td>
<td>x 42%</td>
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<tr>
<td>Available Profit</td>
<td>$380,000</td>
<td>$400,000</td>
<td>$420,000</td>
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<tr>
<td>New Owner Compensation at 27.5%</td>
<td>&lt;$270,500&gt;</td>
<td>&lt;$270,500&gt;</td>
<td>&lt;$270,500&gt;</td>
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<tr>
<td>Available Profit to Capitalize at 20% Rate</td>
<td>$109,500</td>
<td>$129,500</td>
<td>$149,500</td>
</tr>
<tr>
<td>20% Capitalization Rate</td>
<td>÷ .2</td>
<td>÷ .2</td>
<td>÷ .2</td>
</tr>
<tr>
<td>Estimated FMV of the Practice</td>
<td>$547,500</td>
<td>$647,500</td>
<td>$747,500</td>
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Small increases in profitability have significant effects upon practice value.
Chapter 6

NEGOTIATING THE WIN-WIN SALE & ACQUISITION

Assume that the fair market value of the practice and any personal goodwill of the practice owner are agreed upon. Further, assume that the seller/purchaser had also agreed on the date of valuation in the event that the incoming doctor has been an associate in the practice.

The practice would usually be sold in one of two ways; either in a taxable asset or stock sale and acquisition. Under either method, the parties would attempt to maximize the economic benefit and minimize the federal income taxes paid in accordance with applicable tax regulations. To accomplish this objective, the "tax-neutral" fair market value may be adjusted up or down relative to the tax detriment and/or benefit to either of the parties and would consider the following: (a) the contribution which both the purchaser and seller have made to the fair market value, assuming that the purchaser has been an associate in the practice; (b) the amount which would be paid in taxes, both by the seller and purchaser; (c) the terms and conditions of the practice acquisition and sale, e.g., seller assisted financing; (d) depreciation recapture amounts under Internal Revenue Code ("IRC") Sections 1245 and 1250; (e) installment sale regulations under IRC Section 453; (f) the payment of Social Security benefits; (g) tax-qualified retirement plan termination, transfer, rollover and/or distribution; (h) estate planning considerations; and (i) any other matters which may affect either the seller or purchaser. These factors, by their nature, may benefit one party and be a detriment to the other. For this reason, sellers and purchasers of professional practices should be very cautious of allowing one advisor to represent them jointly in a practice sale and acquisition. Once these tax considerations are defined and worked out, the respective accountants for both the seller and purchaser should work out the cash flow for both doctors.

In the process for the sale and purchase, the advisors to both parties should: (a) agree upon the value of the practice; (b) consider the tax effects and possible alternatives; (c) negotiate the "one best method" to complete the transaction; and (d) confirm the outcome or cash flow to each party to the transaction.

Asset Sale

In an asset sale, the purchaser acquires all or part of the seller's assets and probably would not want to assume any of the seller's liabilities, e.g., amounts owed on dental equipment or expansion loans. For the purchaser, due to the "stepped-up" basis to the fair market value of the seller's assets, an asset sale is generally more preferable than the purchase of stock, which is paid in after-tax dollars. An asset purchase allows a purchaser to allocate the purchase price to the assets of the practice in accordance with IRC Section 1060. In other words, the purchaser can amortize or depreciate acquired assets. For example, dental equipment is depreciated over 7 years and goodwill over 15 years.
Reporting Requirements

IRC Reg. 1060-1T(h) requires the seller and purchaser in an asset acquisition each to report on IRS Form 8594 specific information about the allocation of purchase price among the assets transferred. Although the allocation of purchase price on Form 8594 will be binding on both the purchaser and seller, pursuant to a written agreement, the IRS retains the ability to challenge the taxpayer's determination of the fair market value of any asset. If the purchaser and seller have not reached a written agreement regarding to the allocation of the purchased assets, they would file Form 8594 individually. The allocation of the purchase price in a professional practice transfers become more significant at any time when the difference between capital gains and ordinary income treatment widens.

In the event that a C-corporation sells its assets and the retiring or departing owner assigns or sells his or her personal goodwill, another Form 8594 would have to be prepared relative to the personal goodwill in accordance with applicable tax regulations.

Contingent Liabilities

An asset acquisition permits the purchaser to acquire assets of the practice only and not acquire unknown or contingent liabilities. This is not the case in a stock acquisition, although this problem can generally be avoided or minimized by the seller indemnifying or holding harmless the purchaser from any potential liabilities of the practice arising prior to the closing date and the purchaser doing the same for the seller after the closing date.

Like-Kind Exchanges

In an asset acquisition where the doctor is planning to sell his or her practice and purchase another shortly thereafter, IRC Section 1031, like-kind exchange treatment, may be possible. Such treatment would defer any gain to the purchaser on tangible like-kind property, dental equipment, if certain tests are met. It should be noted that the regulations under IRC Section 1031 are relatively complex and require that the new assets, i.e., dental equipment, be identified within 45 days of the closing of the first practice sale. The closing of the subsequent practice purchase must take place within 180 days after the first practice sale. In short, property covered by IRC Section 1031 is deferred from IRC Section 1060 treatment. While IRC Section 1031 usually pertains to real estate, it can also be applicable to dental equipment. Under regulations issued in year 2000, reverse exchanges are now permitted where the second property can be acquired prior to the first property being sold. This change provides additional planning opportunities not previously present in like-kind exchanges.

Goodwill

IRC Section 197 was issued pursuant to the Revenue Reconciliation Act of 1993 and provides for intangible assets including goodwill, going concern value and covenants not to compete to be depreciated by the purchaser over a 15 year period, provided such asset was acquired after August 10, 1993. Prior to this date, goodwill was not depreciable. At that time, covenants not to compete were amortized by the purchaser over the length of the covenant period. This time period was typically three to five years. Currently, covenant compensation...
must also be depreciated over 15 years and would be considered ordinary income to the selling
doctor. If consulting fees or other compensation is paid to the seller for services rendered in the
practice, such amounts are not considered covenant compensation. This compensation would be
currently deductible to the purchaser and would be considered ordinary income to the seller.
Caution; the consulting fees are only deductible where the consulting services are provided.

Personal Goodwill

Since repeal of IRC Section 337, known as the "General Utilities Doctrine", in 1986, a
practice or business which operates as a C-corporation incurs a double tax upon the sale of its
assets. The double tax equates to a 35% tax at the corporate level, and capital gains rates at the
shareholder level when the assets are distributed. Because the largest portion of the selling price
is typically goodwill, this is a significant problem.

Because of the outcome of four tax cases\(^1\), goodwill can be "personal" to the
shareholder/doctor if the C-corporation's revenues are derived from the personal efforts or
reputations of those individuals who are not subject to non-competition provisions or agreements
with the business or practice and there is an appraisal of the personal versus corporate goodwill.
Although still arguable for tax purposes, if the goodwill is an individual asset and not a corporate
asset, then the double tax can arguably be avoided to the extent that goodwill is personal. In
particular, the recent *Howard* case and its Appeal that Dr. Howard lost provide good lessons to
avoid application of a double tax. See Figure 6-1.

Stock Sale

If the practice is organized as an S or C-corporation, the selling doctor can sell either the
assets or the stock of the corporation. For the seller, asset sales are favorable where the seller
operates as a sole proprietorship, general partnership, limited liability company or S-corporation.
Where the seller operates as a professional C-corporation, the seller is subject to two levels of
tax: one on the sale of assets at the corporate level, and the second on the distribution at the
shareholder level. Here, a stock sale is more preferable than an asset sale, triggering only a
single level of tax to the doctor(s)/shareholder(s). Although the sale of stock is taxed at
favorable capital gains rates to the seller, the acquisition of stock in non-deductible to the
purchaser. Nonetheless, the problem of the double tax where a professional C-corporation sells
its assets may be minimized or eliminated by combining the corporate sale of assets with the sale
of personal goodwill of the retiring or departing doctor, consulting agreements, deferred
compensation arrangements and/or non-competition agreements. These agreements must be
legitimate and valid, otherwise the IRS could consider any of these agreements as a "sham" or
"disguised sale" and recharacterize the transaction in an unfavorable manner.

One method to balance the tax disparity in a stock sale is to measure the economic
detriment to the purchaser and economic benefit to the seller, then negotiate a revised purchase

\(^1\) Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998); Norwalk v. Commissioner, 76 T.C. 208
August 29, 2011, United States Court of Appeals for the Ninth Circuit, No. 10-35768, D.C. 2:08-cv-00365-RMP;
price. This same result can be accomplished in an asset sale by balancing the tax detriment to the seller on the C-corporation's sale of its assets against the benefit to the purchaser in the ability to depreciate or write-off the acquired assets. This problem is minimized if personal goodwill is present, as the personal goodwill should arguably only be taxed at one level.

Representations and Warranties

A representation or warranty by the seller is a statement contained within the purchase and sale agreement regarding the status, condition or some aspect of the practice, its financial condition or operation. A representation or warranty may also be made by the purchaser regarding the purchaser's financial condition or ability to acquire the practice, e.g., the purchaser is not under a restrictive covenant provision as a result of prior employment within a specified geographical area of the practice being acquired.

Figure 6-2 provides representations and warranties which may be made by the seller in a practice acquisition. Such representations and warranties are and should be rather detailed. It should be noted that Figure 6-2 is an example of representations and warranties where a practice owner selling stock in the practice. However, if the seller would sell the assets of the practice, as opposed to its stock, the representations and warranties should not differ significantly.

Representations and warranties can be made absolute or "to the best of the seller's knowledge." For example, Section 1.7 of Figure 6-2, provides that, "to the best of Seller's knowledge, the accounts receivable of the practice are fully collectible". This representation may be acceptable to the purchaser as to the accounts receivable because the seller has no knowledge that they are not collectible. This language may not be acceptable to the purchaser as to other Sections contained in Figure 6-2, particularly Section 1.9, Tax Matters, and Section 1.19, Litigation.

The representations and warranties for the purchaser are usually fewer in number than for the seller and usually relate to the purchaser's ability to enter into an agreement for the purchase of the practice.

Indemnification

In the indemnification provisions, the seller would agree to indemnify or hold harmless the purchaser for any breach of the seller's representations and warranties and vice-versa. In such a provision, the seller would hold harmless or indemnify the purchaser for any losses or claims arising prior to the closing date of the acquisition and sale. Alternatively, the purchaser would be asked to indemnify or hold harmless the seller for any losses or claims arising after the closing date of the acquisition and sale. Such provisions can be drafted in a limited or broad manner. The purchaser probably would not agree to indemnify claims of the seller after the closing date relative to the seller providing consulting services or rendering professional services on behalf of the purchaser. Likewise, the seller probably would not agree to indemnify the purchaser prior to the closing date relative to the purchaser working as an employee or independent contractor in the practice. It should be noted that indemnification provisions are only as effective as the ability of the indemnifying party to hold harmless or reimburse the other party for the claim in question. However, where the purchaser pays the seller over time, the
purchaser may desire to negotiate an "offset" provision against sums owed to the seller. An offset provision places the burden on the seller to institute any litigation against the purchaser for the amount of any offset. Finally, the purchaser and seller may wish to indemnify each other for claims in certain situations above or below a certain monetary or "basket" amount. This amount would be subject to negotiations among the parties to the acquisition and sale.

Rework

The sale and acquisition documents should specifically define the possible problem of "rework", whereby the purchaser would feel obligated to the patient to recreate work previously completed by the seller. Rework can be a very sensitive and emotional concern for both the seller and purchaser where it comes up. It can be very significant in crown and bridge practices, orthodontic practice sales and acquisitions and in general practices where orthodontics or "TMJ" treatment has been rendered by the seller. Typically, the seller would not desire to pay or indemnify the purchaser for any rework and the purchaser would desire the seller to complete any rework at his or her expense. This is a subject of negotiation. Misunderstandings between the purchaser and seller may arise by the failure to consider this matter, particularly where seller-assisted financing is in place.

Letters of Intent

A letter of intent is an optional letter agreement that precedes preparation of the purchase and sale agreements. Letters of intent are prepared by the attorney, advisor or broker who represents the seller and sometimes by the purchaser's attorney or advisor. Unfortunately, most 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. The letter of intent is designated in Figure 6-3 is for a complete sale and purchase and does not consider the more detailed letter of understanding for co-ownership.

Is a Letter of Intent Necessary?

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.

- A purchaser received multiple draft versions of agreements that had been prepared by the seller's legal counsel and yet the doctors had not agreed to the purchase price.

- A seller was relocating from the midwest to the south, and there was disagreement over a 15 mile radius of the restrictive covenant.

- A general dentist/seller would not agree to complete unfinished orthodontic cases, even though the purchaser, who did not perform orthodontic procedures, agreed to make arrangements for and pay the seller to do so.

• An 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.

• A seller insisted on continued full-time employment for three years following the sale where production was insufficient for two doctors.

Each of these disagreements could have been avoided had a well drafted letter of intent been prepared because all important aspects of the purchase and sale would have been discussed with the doctors and advisors. Either all important terms would have been agreed upon or one or both parties would walk away.

Letter of Intent Provisions

1. The Parties to the Sale and Purchase. 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 for less than five years, there will be two sellers, the C-corporation and the dentist who sells his or her personal goodwill. On the purchaser's side, the entity through which the purchasing doctor will practice will be the purchaser, not the individual dentist. 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 will, hopefully, also form a limited liability company to purchase any real estate. In the letters of intent that I review, the parties are almost always identified incorrectly.

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! Personal goodwill should be separately appraised.

   The collective purchase price is usually fully payable by wire transfer, bank, or certified check at the closing and terms of any seller financing should be delineated. The purchase price should be reduced by any earnest money deposit, liens on the practice or brokerage fees paid to a broker. Finally, this provision should provide for the purchase price allocation as designated in a schedule to the letter of intent. The purchase price allocation provides how the seller(s) is taxed on the sale and how the purchaser amortizes or deducts 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 the seller's accounts receivable (although not always), cash, cash equivalents, retirement plan contributions 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 that 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, often five percent.
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.

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

7. Earnest Money Deposit. 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. However, 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 purchasing doctor, as security. The earnest money deposits that I usually see are roughly $5,000 and would be returned upon the occurrence of certain contingencies. While the $5,000 does show good faith, my recommendation for an earnest money deposit in this amount is to eliminate it entirely and not take the practice off the market. Another way to handle this is to have a promissory note prepared in a meaningful amount, e.g., $25,000 or $50,000 and signed by the purchaser. In the event that the purchaser backs out of the transaction, the sum of the promissory note becomes immediately due and payable.

8. Confidentiality. While this provision may be in a letter of intent, it should be in an earlier prepared and separate confidentiality letter signed by the purchaser because no purchaser should make an offer on a practice without review of the appraisal and financial information. A confidentiality provision provides that the purchaser will keep the information confidential, but permitted to share it with advisors, and return all of 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 and if the purchaser or purchaser's advisors are not satisfied with the due diligence investigation, any earnest money deposit or promissory note 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. This provision states that the seller will provide 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 time limit and geographic radius or map of the restrictive covenant and non-solicitation provisions for patients and/or referral sources and former employees of the seller.

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 as an independent contractor by purchaser's dental or dental specialty practice for a specified period, e.g., one year.
after closing and by mutual agreement thereafter. Be careful of inappropriate independent contractor relationships as the IRS believes that the retired dentist or specialist is an employee.

14. **Financing.** This provision provides that the purchase and sale is contingent upon the purchaser obtaining lender 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 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 modified right of first refusal for purchase of the real estate at fair market value. There may also be a mandatory purchase of any real estate at a certain point.

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.

17. **Retreatment.** This provision provides that the seller is responsible for retreatment of the selling dentist's patients 12 months prior to closing. In the event that the seller and purchase disagree upon the necessity of retreatment for any patient, an arbitrator would be designated, such as another dentist or dental society peer review committee.

18. **Work-In-Process.** This provision provides that the selling dentist will be permitted to complete cases started, but not finished, prior to closing. Completion of specialty procedures, such as orthodontics, is also delineated. 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. A work in process provision and schedule of cases, patient names and procedures would be included in the purchase and sale agreements.

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.

20. **Definitive Legal Documents.** This provision provides that the purchase and sale is expressly contingent upon and subject to the preparation of legal documents satisfactory to the purchasing dentist, the selling dentist and their respective legal counsel.

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? Once signed by the parties, the lawyer who drafts the purchase and sale agreements prepares them from the letter of intent.

### Obtaining Financing

For the purchasing doctor, you will need a loan not only to finance the acquisition of your practice, but later for purposes of expansion and resource management or, to establish your practice, in the event that you do not acquire one. Whatever your reasons to borrow money, it is imperative to complete an analysis of the loan repayment in light of your anticipated and current
revenues, operating expenses and compensation. In other words, think about repayment of the loan in light of your anticipated cash flow before borrowing the money. The lender needs to know: (a) the purpose of the loan; (b) the amount of the loan repayment; and (c) the sources of loan repayment. The key factors in obtaining any loan are preparation and giving yourself an appropriate amount of time to secure the funds.

Often, purchasing doctors wait longer than appropriate to commence the process of obtaining financing for practice acquisition purposes. This is probably due to the perceived complexity of gathering and preparing the required information to obtain the financing. In preparing an informational package for the lender, consider the following format: (a) projected monthly personal expenses; (b) personal financial statement; (c) projection of first year's practice operations; (d) practice valuation; (e) the names, telephone numbers and addresses of the advisors to the transaction; (f) and due diligence reports; (g) financial statements, including year-to-date, and tax returns for the practice over the last five (5) years; and (h) any other relevant information, primarily relating to the financial condition of the practice being acquired.

Before granting a loan, the lender will review the informational package presented and, usually through the additional step of a loan committee if the lender is a bank, will either grant, conditionally grant, or reject your application based upon your: (a) ability to repay the loan; (b) character; and (c) previous repayment history.

Seller Assisted Financing

An important concern for the seller is being paid the acquisition price for the sale of the practice. Therefore, the seller should not generally be eager to provide the financing. However, in the current economic environment, potential purchasers may not have the ability to obtain financing for the full purchase price, plus working capital. In order to minimize this problem, the practice valuation should prove helpful to a lender as an analysis to show, in quantitative terms and based upon historical results, that the loan for the practice can be repaid, if granted. Nonetheless, many potential purchasers have high debt due to school loans. Add to this the economic crisis which face lenders from time to time and you end up with purchasers without the ability to obtain the financing. Dental lenders remain available to work exclusively with dental and specialty practices and understand the doctor's borrowing needs, as well as the concept of goodwill or a "patient in the chair". These lenders are willing to make loans to dentists and specialists which banks ordinarily would not make, as loan officers usually do not understand the business of dentistry or its specialties. In certain circumstances, your advisors should be able to locate suitable financing for the practice acquisition. However, where financing is obtained, the lender may request the seller to provide some portion of the financing to ensure that the seller assists in the transition of patients to the purchaser. This concept of "shared risk" will be a significant trend in the future.

Generally, practices sell for higher values where some component of seller assisted financing is available than where it is not. Alternatively, the pool of purchasers shrinks where the sale is contingent upon the purchaser financing 100% of the acquisition price.
In the event that the seller is leaving the geographical area or will not otherwise have the ability to return to active practice should the purchaser default on payments of the purchase price, the seller would attempt to receive the purchase price in full, at closing.

The complete sale of a practice should be distinguished from the situation where an associate buys into a practice over a predetermined time period. In this instance, seller assisted financing is much less of a risk to the seller than in a complete sale because the seller remains active in practice.

Where the seller provides financing for the practice sale, the seller should require to obtain the same type and amount of security which a lending institution would require in approving a loan for the acquisition. The personal guarantees of both the purchaser and the purchaser's spouse, if married, should be required in most, but not all circumstances. In most instances, the incoming or purchasing doctor would not desire to provide personal guarantees of parents or relatives personal guarantees. However, if the seller acts as a lending institution, the seller should require the same security as a lending institution. Therefore, the request for the personal guarantee(s) of family members would probably be made.

As an additional consideration for obtaining adequate security by the seller, if some portion of the sale of the practice is through lending institution financing, the lending institution generally requires a first lien on the practice assets being sold. Therefore, in the event of purchaser default, the lending institution is paid prior to the seller. This would be one reason for the seller's need for security similar to that which would be required by a lending institution.

If seller assisted financing is provided, a provision is typically included in the acquisition documents, whereby the restrictive covenants are invalid with regard to the seller upon default of the purchase price by the purchaser. In some states, the purchase price is paid pursuant to a "cognovit" promissory note. A cognovit promissory note is one whereby judgement for default can be taken immediately by the note holder, which cuts off all defenses of the debtor and any appeal of judgment taken on the note.

Another provision is often included in the acquisition documents whereby the purchaser is prohibited from practicing in a specified geographical area, over a specific time period, in the event of default on sums owed to the seller. Here, the seller prohibits purchaser from relocating nearby the acquired practice if the purchaser leaves prior to completing all obligations.

If the seller owns the practice facility, the seller may desire to retain the ability to terminate the lease in the event of non-payment under any seller assisted financing.

Where seller assisted financing is provided, the seller would desire to: (a) know the character of the purchaser to whom the financing is being provided; (b) obtain a substantial down payment; and (c) obtain the same amount and type of security which a lending institution would require in approving the financing. Seller assisted financing is not something which most sellers are eager to provide. However, to the extent that the seller is confident that he or she will be repaid, the interest on the loan can be a worthwhile investment. If granted prudently, seller assisted financing can provide the seller with a "fair" selling price for the practice, while providing the purchaser with an opportunity to acquire the practice which the purchaser would
not otherwise have, but for the financing. A common mistake in this area is for the seller or seller's advisor(s) requesting a selling price so high that the purchaser gets discouraged and defaults. Selling prices are not increasing, they are decreasing.

**Covenants Not To Compete**

The primary value of a practice is its patient base. In acquiring a practice, the purchaser would not desire that the seller to compete after the acquisition is completed, except for those professional services rendered on behalf of the purchaser.

Alternatively, the seller would not desire for the purchaser to possess the ability to render professional services if the purchaser defaults on payment of the acquisition price or as a competing associate of the practice prior to its acquisition.

A covenant not to compete is usually contained as part of the acquisition documents. Although the enforceability of a covenant not to compete varies from state to state and cannot be reduced to a single formula, a covenant will more likely be enforced when it is a reasonable step in carrying out the securing of the goodwill of the acquired practice and is limited to those areas affecting the existence of goodwill.

The Restatement, Contracts, Second provides that promises imposing restraints, covenants not to compete, that are ancillary to a valid transaction or relationship include the following: (a) a promise by the seller of a business (practice) not to compete with the purchaser in such a way as to injure the value of the business sold; (b) a promise by an employee or other agent not to compete with the employer or other principal; and (c) a promise by a partner, or shareholder, not to compete with the partnership, or corporation. To be enforceable, a covenant not to compete must be limited as to the period of time, the area, and the activity involved; this is to indicate that the restraint is no greater than necessary to protect the legitimate interest of the purchaser upon the sale.

Covenants not to compete usually relate to the following: (a) time, e.g., three to seven years; (b) geography, e.g., ten miles, twenty miles, freeway boundaries or some defined location, a county or communities; (c) non-solicitation of patients of the practice or its employees; and (d) trade secrets and confidential information of the practice, e.g., patient lists and/or referral sources.

The sale and acquisition documents described in Figure 6-3 would provide for restriction covenant provisions. The Practice Document Matrix in Figure 6-4 lists the documents necessary for any private practice option.

**Employment or Engagement of the Seller After the Acquisition**

The IRS has made it clear that the retiring dentist or specialist remaining with the purchasing dentist's practice, post-retirement, is an employee and not an independent contractor.
on the basis that the selling dentist or specialist worked for his or her own practice. The retiring dentist or specialist wants to be classified as an independent contractor to deduct direct business expenses, insurances and benefits and the practice pays less tax if the retiring dentist or specialist is an independent contractor rather than an employee. The way around this is for the purchaser's practice to reduce the retired dentist's or specialist's compensation by the full cost of the direct business expenses, insurances and benefits that the retired dentist or specialist would be paid on his or her own on the basis that the reduction is to calculate the retired doctor's pay. It does not change misclassification if the retired doctor works through his or her existing corporation post-sale.

While it is an accepted practice for the purchaser to employ the seller in the practice after the acquisition in order to assist in the transition of patients, the period of time necessary to accomplish the transfer is generally shorter than the purchaser thinks. This assumes that the complete practice is being acquired and sold and that the purchaser and seller are not planning on a co-ownership or solo group arrangement.

There are two reasons for this limited transition period. First, the seller generally desires to be compensated for professional services rendered in the practice, as well as to be paid for his or her presence on the premises of the practice for patient and/or referral source introductions and to answer any questions from the purchaser. Therefore, the seller is typically compensated by way of: (a) payment for professional services rendered; and (b) an hourly, half-day or full-day rate for patient and/or referral source introductory and other consulting services for the purchaser. To the extent that the seller is being compensated for professional services, the cash flow of the practice is reduced. This limits the purchaser's ability to pay the lender and/or seller the purchase price. The end result is that the transition period should last only a short time period of one to three months. In the event that the seller and purchaser plan to work together for more than a short period of time due to the uniqueness of the practice or the seller's desire to continue to work, the impact upon cash flow must be considered.

Second, the practice facility size and design often does not allow for the seller and purchaser to render professional services together, comfortably. Therefore, in order for the seller and purchaser to work at the same time, both doctors tend to be somewhat cramped and inefficient.

These comments are generalizations and exceptions exist. However, for the purchaser to protect himself or herself relative to the seller's rendering of services, professional or otherwise, after the acquisition, the purchaser should retain the ability to limit or terminate the relationship. The seller's purpose should not be to earn a living in the purchaser's newly acquired practice, but to assist in the ownership transition.

An important exception exists in that the selling doctor's anticipated retirement may only be partial and not complete. The parties can definitely negotiate that the selling doctor may

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2 American Bar Association, Section of Taxation, Meeting, September 24, 2010, Toronto, Ontario, Co-Ownership; A Taxing Relationship; Panel Consisted of Assistant Division Counsel, IRS, Small Business/Self-Employed and me.

remain in the practice, even for an indefinite period of time within limitations, to continue to render services on a mutually agreeable basis under agreed upon schedules, compensation, terms and conditions. In fact, the selling doctor may negotiate that his or her restrictive covenants would be null and void if the purchaser inappropriately terminates the seller's employment after the sale.

The Needle in the Haystack

How do the seller and purchaser find each other? Through, in no particular order: (a) practice brokers; (b) dental schools; (c) dental equipment and supply companies; (d) advertisements in local, county, state and national dental publications and journals; (e) dental fraternities; (f) dental laboratory technicians; (g) practice management consultants; (h) accountants and attorneys; (i) newspaper classified advertisements; (j) study clubs; (k) colleagues; and/or (l) a combination of any of the above.

Practice brokers sell many of practices around the country. Although a brokerage fee of approximately ten percent (10%) of the selling price is customarily charged, the ten percent (10%) can be well the fee if the seller cannot find a purchaser or if the candidate/purchasing doctor cannot locate the "right" practice.

Practice Mergers

Practice mergers usually work well for both the retiring and purchasing doctors. Let's say that a retiring doctor is having difficulty locating a purchaser, which will be a future trend due to supply and demand. Often, there is a doctor nearby who could be busier. Your practice can merge into the most desirable of the two facilities and the younger doctor can buy-out the retiring doctor. The economics are usually good in that the overhead of the disappearing practice is easily absorbed into the overhead of the surviving practice. Your dental supply representative can be extremely helpful in this situation because the dental supply representative knows your neighbors who you don't know.

Practice sales and acquisitions work well when the parties and their advisors understand all of the relevant factors relating to the transaction. Where the sale and acquisition is a "win-win" for both the selling and purchasing doctor, the sale and acquisition usually works well.
### Figure 6-1

**LESSONS LEARNED FROM THE HOWARD CASE AND ITS APPEAL**

<table>
<thead>
<tr>
<th>Howard Case</th>
<th>Howard Appeal</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Plan for the sale.</td>
<td>1. Court acknowledged that patient relationships may be personal.</td>
</tr>
<tr>
<td>2. Consider converting to an s-corporation.</td>
<td>2. No corporate goodwill where no covenant not to compete with your corporation is at least an argument.</td>
</tr>
<tr>
<td>3. Authorize an appraisal of the personal goodwill versus any corporate goodwill.</td>
<td>3. Your covenant not to compete should be between you and the purchaser's practice entity, not your practice entity.</td>
</tr>
<tr>
<td>4. Expect increased audits on the sale of personal goodwill.</td>
<td>4. There should not be an independent contractor agreement between your corporation and the purchaser's practice entity.</td>
</tr>
<tr>
<td>5. Personal goodwill in co-ownership buy-outs is a problem due to restrictive covenants.</td>
<td>5. If you have a covenant not to compete with your corporation, it should be terminated.</td>
</tr>
</tbody>
</table>
Figure 6-2

REPRESENTATIONS AND WARRANTIES

1. **Representations and Warranties of Seller.** Seller hereby represents and warrants to Purchaser as follows:

   1.1 **Organization.** The Practice is a professional corporation duly organized, validly existing and in good standing under the laws of the State of ______________, has full corporate power and authority to own all of its property and assets and to carry on its dental practice as it is now being conducted.

   1.2 **Authorized Agreement.** All corporate action by the Practice necessary for the authorization and consummation of the transactions contemplated hereby has been taken.

   1.3 **Valid and Binding Agreement.** This Agreement has been validly executed and delivered by and constitutes a valid and binding obligation of Seller enforceable in accordance with its terms.

   1.4 **Ownership of the Practice.** Seller owns beneficially and of record one hundred percent (100%) of the shares of the Practice's issued and outstanding capital stock, free and clear of all liens, claims, encumbrances or restrictions of any kind, which constitutes the "Shares". Each of the Shares has been duly authorized and validly issued and is fully paid and nonassessable. The Practice has outstanding no other equity securities, or any securities options, warrants or rights of any kind convertible into equity securities of the Practice.

   1.5 **Financial Statements.** Seller has delivered to Purchaser copies of the Practice's financial statements for the fiscal year ended ______________ (herein called the "Financial Statement Date"), and for the fiscal year ended on ______________, of each of the years ______________ and ______________ and notes thereto and the Practice's "Interim Financial Statements" for the period ______________ through and including ______________ (all of which statements are herein collectively called the "Financial Statements"). The Financial Statements have been prepared on a compilation basis and are true, complete and correct, have been prepared, from the books and records of the Practice on a comprehensive basis of accounting, consistently applied for the periods indicated, and which present fairly the financial position and results of operations of the Practice as of the dates thereof and for the periods covered thereby. There are no facts known to Seller which would materially alter the information contained in the Financial Statements.

   1.6 **Inventory.** The Practice's dental supply inventory and dental instruments are merchantable, suitable and usable in the ordinary course of the Practice's business and operations. The Practice's assets include a sufficient (but not an excessive) quantity of each type of such dental supplies and instruments in order to meet the normal requirements of the Practice's business and operations.

   1.7 **Accounts Receivable.** All accounts receivable of the Practice are valid and enforceable. To the best of Seller's knowledge, the accounts receivable are fully collectible.
1.8 **Liabilities.** Except as disclosed in the Financial Statements or on Schedule 1.8 (attached hereto and incorporated herein by reference), the Practice has no debts, liabilities or obligations of any nature whatsoever, whether accrued, absolute, contingent, or otherwise. All deposits, accounts and notes payable, and other liabilities of the Practice are current and not in default.

1.9 **Tax Matters.** The Practice has timely and duly filed with the appropriate governmental agencies all tax reports and returns required to be filed by it. All of such reports and returns are true, correct and complete for the periods covered thereby. The Practice has timely and duly paid all taxes required to be paid by it in respect of the periods covered by such returns. All deposits required by law to be made by the Practice with respect to employees' withholding taxes have been duly and timely made. True and complete copies of all federal income tax returns on Form 1120 for the tax years ending ; ; and as filed with the Internal Revenue Service have been delivered to Purchaser, together with all supporting schedules thereto. There are no federal, state or local tax liens upon any property or assets of the Practice. The Practice has not requested any extension of time within which to file any tax returns which have not since been filed, and no deficiencies for any tax, assessment or governmental charge have been claimed, proposed or assessed by any taxing authority and there is no basis for any such deficiency or claim. As used herein, the term "tax" includes (but is not limited to) all federal, state, and local income, sales, employees' income withholding, social security, franchise, property, and all other governmental taxes, fees and charges.

1.10 **Title to and Condition of Property.** The Practice has good and marketable title to and rightful possession of all assets it owns, except assets sold or otherwise disposed of in the ordinary course of the Practice's business and operations, free and clear of all liens, security interest, encumbrances, and restrictions, except: (i) liens for current taxes not yet due and payable; and (ii) liens or encumbrances described in Schedule 1.10 (attached hereto and incorporated herein by reference). Purchaser acknowledges that Seller is making no representation or warranty with regard to the condition or use of the assets of the Practice, except as expressly set forth in this Agreement.

1.11 **Compliance with Law.** The Practice has been and is being conducted in compliance with all applicable federal, state and/or local laws, rules, regulations and orders, non-compliance with which would have a material and adverse affect on the Practice, its business and operations, or its assets.

1.12 **Insurance.** Schedule 1.12 (attached hereto and incorporated herein by reference) lists all insurance policies maintained by the Practice, showing the types of coverage, policy expiration dates, policy numbers and policy limits as to each such policy. All such policies pursuant to which coverage exists are in full force and effect and have been issued under valid policies for the benefit of the Practice by insurance carriers licensed to do business in . The consummation of the transactions contemplated hereunder shall not cause the termination or cancellation of any such insurance policy.
1.13 **Contracts and Leases.** Except as disclosed on Schedule 1.13 (attached hereto and incorporated herein by reference), the Practice is not a party to any written or oral contract, lease or commitment. All agreements listed in Schedule 1.13, to the extent that the same grants rights to the Practice, are enforceable by the Practice and the Practice has not received notice of any claim to the contrary. Each agreement listed in Schedule 1.13 is in full force and effect, constitutes a legal, valid and binding obligation of the respective parties thereto, enforceable in accordance with its terms, except as indicated in Schedule 1.13. Complete and correct copies of all written items listed in Schedule 1.13 have been made available to Purchaser prior to the execution of this Agreement.

1.14 **Defaults.** Except as listed in Schedule 1.14 (attached hereto and incorporated herein by reference), all parties obligated under the agreements listed on Schedule 1.13 are in compliance in all material respects with the terms thereof and there has been no notice of default or termination.

1.15 **Transactions with Seller.** Except as disclosed on Schedule 1.15 (attached hereto and incorporated herein by reference), the Practice does not owe any amount to, or have any contract with or commitment to, Seller (other than compensation for current services not yet due and payable and reimbursement of expenses arising in the ordinary course of business), and Seller does not owe any amount to the Practice.

1.16 **Employee Benefit Plans.** Except as disclosed on Schedule 1.16 (attached hereto and incorporated herein by reference), the Practice has not and does not sponsor, maintain or contribute to any employee pension benefit plans within the meaning of Section 3(2) of the Employee Retirement Income Security Act of 1974 ("ERISA") or any other program or arrangement under which the Practice has any obligations in respect of, or which otherwise cover, any of the current or former employees of the Practice, or their beneficiaries. Each terminated qualified retirement plan (within the meaning of Section 401(a) of the Internal Revenue Code), herein called the "Terminated Plan;": (a) has received a favorable determination letter from the Internal Revenue Service with respect to its termination; and (b) was terminated in accordance with all applicable federal, state and local laws, rules and regulations. In addition to and no in limitation of the indemnification provisions contained in Section __________ hereof, Seller hereby agrees to indemnify and forever hold harmless Purchaser, individually and jointly, from and against any and all actions, causes of action, liabilities, damages, penalties, costs and expenses (including, but not limited to, attorneys' fees) directly or indirectly arising from or related to the Terminated Plan.

1.17 **Other Employee Matters.** Except as disclosed in Schedule 1.17 (attached hereto and incorporated herein by reference), the Practice has no plans and/or policies with respect to vacation pay, holiday and/or sick pay, pension and profit-sharing contributions, health, medical or any other type of employee welfare benefit plan within the meaning of Section 3(1) or ERISA to which the Practice presently contributes or is required to contribute, nor is the Practice indebted to any employee other than for wages and benefits earned during the current payroll period which are not yet due and payable. Except as set forth on Schedule 1.17, there are no controversies pending between the Practice and any of its employees, which controversies have affected or may affect materially and adversely the business, operations, assets, prospects or condition (financial or otherwise) of the Practice.

1.18 Absence of Certain Changes. Except as set forth in Schedule 1.18 (attached hereto and incorporated herein by reference), during the period from the Financial Statement Date to the Closing Date, the Practice has not and will not have:

(a) Experienced any change in its business, financial condition or operations which may have any material adverse effect on the Practice, its financial condition, its operational results or patients; or

(b) Incurred any obligation or liability, except current (liabilities incurred in the ordinary course of business and consistent with its prior practice;

(c) Failed to replenish its inventory of dental supplies and instruments in a normal and customary manner consistent with its prior practice;

(d) Created or suffered to exist any lien, claim or encumbrance with respect to its assets;

(e) Sold, transferred or otherwise disposed of any assets or properties of the Practice other than in the ordinary course of its business;

(f) Forgiven or cancelled any debts or claims, or waived any contractual or other rights; or

(g) Otherwise conducted its business or entered into any transaction, except in the usual and ordinary manner and in the ordinary course of its business.

1.19 Litigation. No litigation or other judicial, administrative or investigative proceeding is pending or threatened against or affect the Seller, the Practice or its assets.

1.20 Consents. To the best of Seller's knowledge, no consents or approvals of any third party are required or will be required in order to permit the consummation of the transactions contemplated by this Agreement.

1.21 Permits and Licenses. Schedule 1.21 (attached hereto and incorporated herein by reference) sets forth all licenses and permits issued by applicable governmental authorities presently held by the Practice with respect to the operation of its business. Seller has not received notice of any violations with respect to any of such license or permits.
1.22 **Bank Accounts.** Set forth in Schedule 1.22 (attached hereto and incorporated herein by reference) is an accurate and complete list, disclosing the name and address of each bank in which the Practice has an account or safe deposit box, the number of any such account or any such box and the names of all persons authorized to draw thereon or to have access thereto.

1.23 **No Guaranties.** None of the obligations or liabilities of the Practice are guaranteed by any other person or entity, nor has the Practice guaranteed the obligations or liabilities of any other person or entity.

1.24 **Title to the Shares.** Seller has valid and unencumbered title to the Shares, free and clear of all restrictions, liens and encumbrances, and has full legal right, power and authority to enter into this Agreement, to sell, assign, transfer, and deliver the Shares hereunder, and to perform his other obligations under this Agreement. Upon delivery of and payment for the Shares, Purchaser shall acquire title thereto, free and clear of all liens, restrictions or encumbrances.

1.25 **Correctness of Representations and Warranties.** The representations and warranties made by Seller herein or in any certificate to be furnished to Purchaser or Purchaser's counsel pursuant hereto, or in connection with the transactions contemplated hereby, do not contain and, at the Closing, shall not contain any untrue statement of a material fact and do not omit and shall not omit to state all material facts necessary to make the statement or facts contained therein not misleading. All statements made and data presented by Seller in this Agreement and in any certificate or schedule provided to Purchaser by Seller pursuant hereto shall be deemed to be representations and warranties under this Agreement to Purchaser by Seller.
LETTER OF INTENT

ACQUISITION OF STOCK OR ASSETS?

[FIRM NAME]

[Insert Date]

[Insert Name, Esq.]
[Insert Address]

RE: Letter of Intent For Sale and Acquisition of Dental Practice xx[and Real Estate]xx

Dear [Insert Name]:

Our Firm is counsel to __________, P.A. ("Seller") and __________, D.D.S. ("Dr. [Seller]"). As such, this letter is intended to serve as a letter of intent for: (a) the purchase and sale of Seller's assets and personal goodwill by __________, P.A. ("Purchaser"); xx[and (b) the purchase and sale of real estate occupied by Seller from __________, LLC ("Real Estate, LLC") by __________, D.D.S. ("Dr. [Purchaser]") or an entity wholly owned by Dr. [Purchaser] and/or his/her spouse ("Real Estate Purchaser").

1. Acquisition. Purchaser will acquire the assets (the "Assets") of Seller and the personal goodwill (the "Personal Goodwill") from Dr. [Seller].

2. Purchase Price, Payment and Purchase Price Allocation. The collective purchase price for the Assets and the Personal Goodwill shall equal __________ Dollars ($_________)(collectively the "Purchase Price") and shall be payable at Closing (as herein defined) by bank or certified check, reduced by the Earnest Money Deposit, Liens and Brokerage Fees (as herein collectively defined). The Purchase Price allocation shall be as designated in Schedule 2 (attached hereto and incorporated herein by reference).

3. Excluded Assets. The Purchase Price excludes Seller's accounts receivable, cash, cash equivalents and Seller's debt (unless specifically assumed by Purchaser) and personal items of Dr. [Seller] as designated in Schedule 3 (attached hereto and incorporated herein by reference).

4. Accounts Receivable. Seller's accounts receivable will be collected by Purchaser for a period of six (6) months following Closing, less an administrative fee of five percent (5%). At such time, the unpaid list of accounts receivable shall be turned over to Seller with no further responsibility for collection by Purchaser. Seller's accounts receivable shall be collected by 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 Purchaser through Dr. [Purchaser].
5. **Assets Free and Clear of Liens and Encumbrances.** At Closing, the Assets shall be free and clear of all liens and encumbrances (collectively the "Liens"), unless specifically assumed by Purchaser as a schedule to the Agreements (as herein defined).

6. **Brokerage Fees.** Any and all brokerage fees (the "Brokerage Fees") shall be the sole responsibility of Seller.

7. **Earnest Money Deposit.** As the date of this letter, Purchaser shall deliver to Seller an Earnest Money Deposit (the "Earnest Money Deposit") in the amount of _______________ Dollars ($_______) xx[in the form of a promissory note]xx in the sum of _______________ Dollars ($_______). In exchange for the Earnest Money Deposit, Seller shall not sell its dental practice to any other individual or entity, other than Purchaser, until Closing, except as described herein. The Earnest Money Deposit shall be retained by Seller as liquidated damages and not as a penalty if Closing does not occur for any reason, except as described in Sections 17, 18, 19, 20 or 21 herein. Upon the occurrence of a Contingency (the "Contingencies"), your firm will notify us, in writing, and Seller shall promptly return the Earnest Money Deposit to your office for return to Purchaser or Dr. [Purchaser's] guardian or estate, as the case may be.

8. **Confidentiality.** During negotiations regarding Purchaser's proposed acquisition of the Assets and Personal Goodwill, Purchaser will have access to and will be requesting certain of the following information regarding Seller and its patients xx[and referral sources]xx (all of which information is herein collectively called the "Confidential Information"): patient xx[and referral source]xx lists, records and other information regarding Seller's patients xx[and referral sources]xx (whether or not evidenced in writing); patient fee schedules and fee policies, financial plans, records, ledgers and information; employment records, data and policies; business and practice methods and operations; business and practice forms, correspondence, memorandums and other records; and any other confidential information which Purchaser encounters during Purchaser's review of the transactions contemplated by this letter. In consideration of the release by Seller of the Confidential Information to Purchaser, Purchaser agrees that: (a) the Confidential Information shall (at all times) be and remain the exclusive property of Seller; and (b) Purchaser shall hold the Confidential Information as a trustee and fiduciary for Seller; and (c) Purchaser shall not directly or indirectly use for any purpose, copy, retain or disclose or convey to any third-party, except Purchaser's advisers, any Confidential Information without the prior written approval of Seller. If negotiations for the transactions contemplated by this letter terminate for any reason, Purchaser shall promptly return all Confidential Information to Seller.

9. **Closing.** Closing for Purchaser's acquisition of the Assets and Personal Goodwill shall occur on or before the commencement of business on ____________, 20__, unless otherwise agreed to by Purchaser and Seller in writing.
10. **Representations and Warranties.** Seller shall provide Purchaser with representations and warranties suitable to Purchaser that will be contained in the purchase and sale agreements (collectively, the "Agreements").

11. **Non-Competition/Non-Solicitation.** Seller shall provide Purchaser with a restrictive covenant and non-solicitation provisions contained in the Agreements for employees of the practice, patients and xx[referral sources]xx of the Practice, irrespective of the geographic radius of the restrictive covenant. The restrictive covenant shall be for a period of ________ (__) years after the date that Dr. [Seller] is no longer employed by xx[engaged as independent contractor in]xx xx[Purchaser's dental practice and]xx the radius shall be ________ (__) miles in all directions from the premises of Seller located in _______________, _______________, _______________ (the "Premises") in the area described in the map as delineated in Schedule 11 (attached hereto and incorporated herein by reference).

12. **Post-Closing Employment of Dr. [Seller].** At Purchaser's discretion, Dr. [Seller] shall be employed by Purchaser's dental practice for a period of one (1) year and by mutual agreement thereafter. Dr. [Seller's] compensation shall equal the greater of: (a) thirty-five percent (35%) of collections attributable to professional dental services rendered by Dr. [Seller] to former patients of Seller and to patients of Purchaser's dental practice, including hygiene examination fees and excluding hygiene services and x-rays performed by Purchaser's hygienist(s); or (b) $______________ per "Work Day". For purposes of this agreement, a Work Day means Dr. [Seller] being available to render professional dental services on the Premises during Purchaser's usual hours of operation. Seller and Purchaser acknowledge and agree that Dr. [Seller] shall be scheduled for _______ Work Days per week as designated in Schedule 12 (attached hereto and incorporated herein by reference). Seller and Purchaser further acknowledge and agree that a substantial portion of Dr. [Seller's] services will be to transfer Dr. [Seller's] goodwill, patients, and xx[referral sources]xx to Purchaser and to the extent that Purchaser no longer needs Dr. [Seller's] services, Purchaser may terminate Dr. [Seller's] employment xx[engagement]xx with Purchaser's dental practice with thirty (30) days written notice.

**Why Not A Contractor?**

13. **Retreatment.** Seller and Purchaser acknowledge and agree that Purchaser shall not be responsible for any defective professional dental treatment rendered by Dr. [Seller] to Seller's patients for the twelve (12) month period immediately preceding Closing.

14. **Orthodontic Cases.** Seller and Purchaser acknowledge and agree that Purchaser shall not be responsible for the continued treatment of orthodontic cases previously started by Dr. [Seller] on behalf of Seller. Such orthodontic cases shall be considered Work in Process (as herein defined).
15. **Work in Process.** Seller and Purchaser acknowledge and agree that Dr. [Seller] shall be permitted to finish those cases started, but uncompleted, prior to Closing as described by a Schedule to the Agreements (the "Work in Process"). Seller shall be entitled to all fees for the Work in Process and responsible for the payment of any dental supplies and laboratory fees and the use of any chairside assistant employed by Purchaser. Seller's use of the Premises shall be limited to those days and times described in Schedule 12.

16. **Mutual Indemnification.** Seller shall indemnify and hold harmless Purchaser and Dr. [Purchaser] for all aspects of Seller's operation of its dental practice prior to Closing and Purchaser shall indemnify and hold harmless Seller and Dr. [Seller] for all aspects of Purchaser's operations of its dental practice following Closing.

17. **Due Diligence.** For a period of ________ (_______) days following the date that this letter is signed by Seller and Purchaser (the "Due Diligence Period"), Purchaser shall review and confirm the Confidential Information to Purchaser's satisfaction. If Purchaser is not satisfied with Purchaser's due diligence investigation within the Due Diligence Period, the terms of this letter shall be null, void and without effect.

18. **Financing.** Purchaser's acquisition of the Assets and Personal Goodwill is expressly contingent upon Purchaser obtaining "reasonable" financing for the Purchase Price on or before Closing.

19. **Lease Assignmentxx/Lease/Real Estate Option/Modified Right of First Refusalxx.** Purchaser's acquisition of the Assets and Personal Goodwill is expressly contingent upon Purchaser obtaining a "reasonable" lease assignment or lease for the Premises on or before Closing. Consider real estate provisions.

20. **Death or Permanent Disability.** If Dr. [Purchaser] dies or becomes permanently disabled (as herein defined), this letter shall be null, void and without effect. For purposes of this Agreement, permanent disability means any physical or mental condition that could reasonably be expected to prevent Dr. [Purchaser] from practicing dentistry for more than one year as determined by a physician selected by Dr. [Purchaser] or Dr. [Purchaser's] guardian, as the case may be.

21. **Definitive Legal Agreements.** This letter and the acquisition and sale of the Assets and Personal Goodwill hereunder is expressly subject to the preparation of legal documents in form and substance satisfactory to this Firm on behalf of Purchaser and Dr. [Purchaser], and your office on behalf of Seller and Dr. [Seller].

If this letter is acceptable, please ask Dr. [Purchaser] to sign and date where indicated on behalf of Purchaser and return a signed and dated copy of signed letter to our office. Upon receipt of the signed letter, I will ask Dr. [Seller] to sign this letter on behalf of Seller and will
return a fully-signed copy of this letter to you. Thereafter, I will promptly commence preparation of the sale and acquisition agreements.

Thank you again for your help and assistance in this matter.

Sincerely yours,

[FIRM NAME]

By: [Name]

cc: Dr. [Seller]
    Local Counsel
    Accountant

I have read this letter and accept the terms and conditions stated herein.

*Purchaser's practice entity is not yet formed.

Date: ____________________________

Dr. [Purchaser]

- Purchaser -

SELLER, D.D.S., P.C.

Date: ____________________________

By: ____________________________

Dr. [Seller], President

-Seller -
Figure 6-3

Schedule 2

Purchase Price Allocation

[To Be Attached Prior to Signing]
Figure 6-3

Schedule 3

Excluded Assets

[To Be Attached Prior to Signing]
Figure 6-3

Schedule 11

Restrictive Covenant Map

[To Be Attached Prior to Signing]
### Figure 6-3

#### Schedule 12

**Work Days Seller**

<table>
<thead>
<tr>
<th>Day(s)</th>
<th>Time(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monday</td>
<td></td>
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<tr>
<td>Tuesday</td>
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<tr>
<td>Wednesday</td>
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<td></td>
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<tr>
<td>Friday</td>
<td></td>
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<tr>
<td>Saturday</td>
<td></td>
</tr>
<tr>
<td>Establish Practice</td>
<td>Sell/Acquire Practice</td>
</tr>
<tr>
<td>-----------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>2. Form Operating Entity (Corporate or Non-Corporate Form)</td>
<td>2. Asset or Stock Purchase Agreement</td>
</tr>
<tr>
<td></td>
<td>5. Pledge and Security Agreement</td>
</tr>
<tr>
<td></td>
<td>6. Bill of Sale</td>
</tr>
<tr>
<td></td>
<td>7. Restrictive Covenant Agreement</td>
</tr>
<tr>
<td></td>
<td>8. Employment Agreement for Former Owner, if Applicable</td>
</tr>
<tr>
<td></td>
<td>9. Consulting Services Agreement for Former Owner, if Applicable</td>
</tr>
<tr>
<td></td>
<td>10. Deferred Compensation Agreement-Already in Effect</td>
</tr>
<tr>
<td></td>
<td>11. Lease Agreement</td>
</tr>
<tr>
<td></td>
<td>12. Memorandum of Lease/For Recording Purposes</td>
</tr>
</tbody>
</table>
Chapter 7

ACQUIRING YOUR PRACTICE —
THE IMPORTANCE OF PURCHASER DUE DILIGENCE

Due diligence has been defined as "such measure of prudence as is properly to be expected from and ordinarily exercised by a reasonable and prudent man under the particular circumstances, not measured by any absolute standard, but depending on the relevant facts of the special case."1

The purpose of the due diligence or purchase investigation is to determine whether the acquisition should be made and, if so, to determine the purchase price, terms and conditions of the proposed transaction, irrespective of a complete purchase and sale, co-ownership or other practice entry choice. The due diligence or purchase investigation is the legal, accounting and business homework which is necessary to ensure that you are actually receiving what you are paying for regarding the purchase of a particular practice. You and your advisor(s) should review, question and probe the disclosure schedules which would be completed by the seller and/or the seller's advisor(s).

The closer you become to making an informed decision to acquire all or a portion of a particular practice, the more critical the due diligence process becomes. One method of analyzing the due diligence process is to categorize it into three (3) components: (a) comparison of your practice options; (b) preparation or confirmation of the proposed practice valuation, structure and terms of the acquisition; and (c) confirmation that you are actually receiving what you think you are purchasing.

A big part of the due diligence is the determination of the percentage of patients or referral sources that will remain with your practice. If 90% of patients remain, as opposed to 100%, this is a significant factor in determining practice value. In addition, there is a trend for the seller not to inform staff that a complete purchase and sale will take place and brokers usually will not permit staff interviews prior to closing of the sale. If key staff will not remain with your practice, how does this affect your revenue and profitability? I recently spoke with a dentist who purchased a practice where staff was not informed of the pending sale in a general practice. After the sale, one hygienist retired and other left to work at a competing practice. These are risks that affect what you should pay for a particular practice.

Comparison of Practice Options

It is advisable to compare your options for entering practice in light of: (a) the available opportunities within the specified geographical area(s) where you intend to practice; and (b) your

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personal goals and financial situation. This form of homework takes place on a personal level and with the least economic/advisory cost to you, depending upon the amount of effort which you are willing to put forth.

**Preparation or Confirmation of the Practice Valuation**

The second category of the due diligence process is the preparation or confirmation by you and/or your advisor(s) of the practice valuation in light of the revenue and profitability of the particular practice. Although there exist numerous practice characteristics which impact practice value (e.g., percentage of active patients in recall program to total number of active patients for a general practice, number of new patients per month, percentage of practice in fee for service, etc.), all such characteristics affect both revenue and profitability in some way over the long term.

As part of this process, it is essential for your accountant to prepare a budget of your anticipated practice revenue and operating expenses in light of the historical data relative to the practice, anticipated future events and expenditures. An example of a future event and expenditure would be an anticipated relocation of the practice with the corresponding costs (e.g., plumbing, electrical, carpentry, decorating and equipment replacement costs). Such costs should be anticipated as part of the homework process to ensure that the requested purchase price of the practice is fair to both you and the seller. Without the proper homework on your part (and your advisor(s)), you cannot assess the cash flow which you will incur in your newly acquired practice.

Therefore, the second category of the due diligence process is to prepare or confirm the value of the particular practice. However, to do so, it is imperative that your accountant prepare a verification analysis so that after the acquisition, based on historical practice data, you will expect to: (a) earn a reasonable living; (b) pay the operating expenses which you will incur in the practice; (c) pay the lender(s) the purchase price for the practice; and (d) within a measured time period not to exceed seven years, irrespective of the term of your loan.

The more complete, accurate and reliable the information for which to value the practice or to assess the accuracy of an existing valuation, the easier it will be for you to make an informed decision as to whether to proceed with a particular acquisition. Assuming that it is your intention to purchase a particular practice, it is critical to obtain relevant information about it in order to determine or confirm the purchase price and terms. In this regard, the items provided contain the due diligence checklist, Figure 7-1 and indicated by asterisk, are the items which should be requested from the seller or seller's accountant to prepare or confirm the valuation report.

It should be noted that item E.6 of Figure 7-1 provides for a written analysis of the geographical and area demands for a dentist/specialist. In preparing this report, list the number of dentists/specialists in the geographical area where you intend to practice, the number of people living in the area, and the income, age and demographic trends of the area population.
Because some areas will grow and others will decline, you should assess your economic ability to meet your revenue projections in light of your operating expenses over the long term.

At the time when the practice valuation is being prepared or confirmed, you are not yet in the final, or "in depth", stage of the due diligence process. While the second category or level of due diligence is detailed, you have not yet made the decision to acquire this particular practice. Once that decision is made, the final component or most detailed level of due diligence takes place.

**Confirmation of Value**

Confirmation of value or attempting to ensure that you are really receiving what you are paying for is the traditional form of due diligence.

The "Due Diligence Checklist" provided in Figure 7-1 contains the information which should be requested and reviewed by you and/or your advisor(s) relative to the practice being acquired. While not every category contained in the Due Diligence Checklist will be applicable to each acquisition, it is surprising as to how much about the operation of a particular practice is taken for granted without appropriate review. The more homework which you and your advisors complete relative to the purchase investigation, the greater your chances of a successful acquisition.

One method to assess the due diligence process, its three (3) categories, is by way of two (2) types of factors: (a) those economic in nature; and (b) those with regard to minimizing the legal risks associated with practice ownership.

The economic and risk factors can be measured against the classifications described in Figure 7-1: (a) Compatibility of Purchaser and Seller; (b) Financial Information; (c) Practice Facility; (d) Lease and Real Estate Matters; (e) Operations; (f) Employment Relations and Benefits; (g) Litigation, Pending/Threatened; and (h) Organizational Matters.

**Compatibility of Purchaser and Seller**

Irrespective of how favorable the operational and financial results of a particular practice are, you and the seller should be compatible in your ethics and philosophy relative to the profession of dentistry or your specialty. In order to assess your compatibility, you and the seller should spend the appropriate amount of time together to determine the extent that you share similar practice values.

**Financial Information**

Much of the financial information relative to the particular practice and its operational results is obtained prior to preparation or confirmation of the practice valuation. The financial information should be reviewed to ensure that it is accurate, consistent and complete, as your decision to acquire a particular practice will primarily be based upon its historical financial data.

In this regard, the seller is typically asked to make certain representations and warranties regarding the financial information. The representations and warranties would be provided in the sale and acquisition documents.

Review the aging of the accounts receivable and the historical collection rate of the practice. A practice may have a significant amount of uncollectable accounts receivable which have never been written-off and have accumulated over a long period of time. Therefore, accounts receivable are an important area for your review, irrespective of whether the accounts receivable are acquired by you or paid to the former owner, as collected.

**Practice Facility**

The necessity for due diligence concerning the practice facility is based upon the need for: (a) future renovations; (b) a possible relocation; (c) an expansion; or (d) replacement of dental equipment, office equipment, computer equipment and/or furniture. For example, unless maintenance records for dental equipment are examined or the dental dealer (yours, the seller's or both) complete a thorough maintenance inspection, you will not easily have the ability to assess future expenditures. These expenditures will impact your practice cash flow and compensation after the acquisition.

**Lease and Real Estate Matters**

In acquiring a particular practice, you will: (a) obtain a lease, or lease assignment, for the premises of the practice; (b) purchase the premises, land and building/condominium; or (c) negotiate an option and/or right of first refusal to purchase said premises at a future date, as either a part of the lease or in a separate document. As such, it is critical that certain homework be completed regarding environmental matters, easements, zoning, etc.

**Operations**

Homework on practice operations is important to assess the growth, stability and quality of professional services for the practice.

For example, review the patient charts. Too often, purchasing doctors do not appropriately review the appointment book and all patient charts prior to the acquisition. Unless you review the charts, you cannot assess critical characteristics of the patients and procedures performed by the practice.

**Employment Relations and Benefits**

In acquiring a practice, it is important to assess the manner in which the staff interacts with each other, as well as the practice owner(s). You need to know the employees which you desire to retain in the practice after its acquisition, and whether such employee(s) intend to remain in the practice, their quality of performance, their compensation levels and benefits. For example, if the current owner(s) funds a substantial retirement contribution on behalf of rank and
file employees, your cash flow during your early years as a practice owner may be correspondingly reduced. However, you may desire to retain the goodwill of staff members, irrespective of whether you have sufficient cash flow to sustain the current level of benefits. It is this type of information which is evaluated as part of the homework process. This type of information may also impact the purchase price which you would be willing to pay for a particular practice.

**Litigation — Pending/Threatened**

If there is any potential, pending or threatened action, investigation, complaint, audit or litigation which may affect you as the new owner of the practice, you need to know about it. You are acquiring a practice, not its problems; current, past, pending or threatened. The representations and warranties which the seller and/or professional corporation would be asked to make about the practice would include those relating to litigation.

**Organizational Matters**

The homework on organizational matters typically relates to the acquisition of a professional corporation or limited liability company. You need to know that the formalities required by state and federal laws are complied with in order for you not to become potentially liable for any liabilities of the practice being acquired or of its owner(s).
## DUE DILIGENCE CHECKLIST

* Designates that the due diligence information should have been requested, reviewed and used as part of the preparation or confirmation of the practice valuation.

<table>
<thead>
<tr>
<th>Completed</th>
<th>Not Completed</th>
<th>Inapplicable</th>
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### A. Compatibility of Purchaser and Seller

1. Contrast seller(s) practice mission and philosophy to yours;

2. Contrast seller(s) personal values and work ethic to yours;

3. Assess seller(s) reason for departure from active practice;

4. Assess reputation of the practice and practice owner(s) within the community and among colleagues; and

5. Assess willingness of seller(s) to transfer ownership of the practice.

### B. Financial Information

1. Obtain federal income tax returns of the practice for the lesser of the last five fiscal years or the number of years in practice;

2. Obtain financial statements and balance sheets (assuming that they are prepared for the practice) for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

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**Figure 7-1**

3. Obtain an aged trial balance of all practice accounts receivable and the historical practice collection records for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

4. Obtain appropriate certificates of payment from state authorities evidencing proper payment of or provision for sales taxes, workers' compensation premiums and unemployment compensation premiums;

5. Obtain list of bank accounts and lenders for the practice;

6. Obtain copies of any equipment lease and/or loan agreements or line of credit agreements with lenders for the practice and a list of those individuals guaranteeing said agreements;

7. Obtain specific amounts of gross production and collections by individual doctor and hygienist(s) for the lesser of the last five fiscal years or the number of years in practice and the current year to date;

8. Obtain listing of all accounts receivable written off and/or sent to any collection agency or attorney in each of the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date; and

9. Obtain itemized list of all leasehold improvement costs made in the current practice facility and the date(s) said leasehold improvements were made.

10. Your accountant should prepare your financial budget for the practice being acquired.

11. Your accountant should assist you in the preparation of your personal financial statement to assess your current financial situation and ability to obtain financing for the purchase price of the practice.
C. **Practice Facility**

1. Obtain floor plan of the practice facility;

2. Obtain an itemized list and the fair market value of all dental equipment being acquired by treatment room, plus darkroom, utility room, sterilization area, x-ray area and laboratory;

3. Obtain an itemized list and the fair market value of all office equipment and furniture being acquired;

4. Obtain an itemized list and the fair market value of all tangible assets, personal and other items located in the practice facility not being acquired;

5. Obtain an itemized list and the fair market value of all tangible assets (dental equipment, office equipment and furniture) leased by the practice or located in the practice facility to which the practice does not hold clear title;

6. Obtain maintenance records for all dental and office equipment from the date of purchase through the current date;

7. Assess overall appearance, aesthetics and condition of practice facility;

8. Determine whether dental equipment is right or left handed in light of your ability to practice comfortably and efficiently;

9. Review your ability to expand the current practice facility; and

10. Assess current parking availability.

D. **Lease and Real Estate Matters**

1. Obtain copy of any current lease, any renewal amendments and any document evidencing recording of the lease;
**Figure 7-1**

*2. Obtain copies of any deed, documents and/or agreements relating to the practice owner's (or family members') ownership of the practice real estate;*

*3. Obtain copies of any surveys, plans, blueprints, specifications and other technical documents relating to the practice real estate, improvements, sewerage, etc.;*

*4. Obtain copies of any environmental or other regulatory permits, proceedings, abatement proceedings or any other regulatory matter affecting the practice real estate;*

*5. Obtain copies of any title insurance policies and environmental audits relative to the practice real estate;*

*6. Obtain copies of any contracts to sell, purchase or lease the practice real estate;*

*7. Obtain copies and/or list of any insurance policies for the practice real estate;*

*8. Obtain list of any zoning, public health, building code or other violations for the practice real estate for the lesser of the last five calendar years or the number of years the seller owned the practice real estate and the current year to date; and*

*9. Obtain list of any material easements, licenses or other rights-of-way granted relative to the practice real estate.*

**E. Operational Matters**

*1. Obtain number of active patients (patients treated in the past twenty-four consecutive months), as well as the number of inactive patients (those patients not having any dental services rendered within the last twenty-four consecutive months);*
Figure 7-1

*2. Obtain a summary of the number of new patients in each consecutive month for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

*3. Obtain the number of the current patients (and percentage of the practice) in recall, if applicable;

*4. Obtain a current fee schedule and a summary of fee increases for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

*5. Obtain a specific list of those procedures performed by the practice and those referred to specialists, if applicable;

*6. Provide your written evaluation of the area demand and potential for economic growth for a dentist/specialist in the geographical area where you intend to practice;

7. Obtain reports demonstrating practice compliance with OSHA and State Dental Board Regulations;

8. Assess stability of the practice and surrounding community;

9. Assess competition in the geographical location of the practice;

10. Assess practice location;

11. Review demographic characteristics of patients (location, age and income);

12. Determine availability of seller assisted financing;

13. Determine the number of hours and days worked per month by the dentist(s)/hygienist(s);

14. Determine the amount of time taken off by the practice owner yearly;
15. Determine the number and percentage of patients in the practice covered by insurance/managed care/medicaid/other;

16. Assess availability of public transportation;

17. Review all current patients' charts, manner of payments, patient demographics, etc.;

18. Review quality of the manner in which patient records and charts are retained in the practice;

19. Review effectiveness of management systems;

20. Review entity type/completeness of legal and accounting records;

21. Obtain list of all contracts or other agreements to which the practice is a party;

22. Obtain copies of all insurance policies for the practice;

23. Obtain copies of any current third-party payment contracts;

24. Copies of all licenses, permits, registrations, certificates, consents, accreditations and approvals needed to conduct the operation of the practice;

25. Obtain list of all names, trade names, d/b/a, etc. used in the practice for the lesser of the last five fiscal years or the number of years in practice;

26. Obtain copy of any broker, finder or other contract requiring the payment of a fee in connection with the sale of the practice;

27. Calculate the current percentage of case acceptance rate as a percentage of all cases presented for treatment in the practice; and
Figure 7-1

28. Obtain copies of any shareholder or member operational agreements (e.g. buy/sell agreements, deferred compensation agreements, employment agreements or close corporation agreements, etc.);

F. Employment Relations and Benefits

*1. Obtain a census of all employees of the practice, the hours worked, compensation levels, positions, responsibilities and dates of hire (including former employees) for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

*2. Obtain copies of all employee handbooks, job descriptions and/or other publications distributed to employees of the practice;

3. Obtain copies of all employee benefit plans (and summary plan descriptions) for the practice, including defined benefit, defined contribution, medical, severance, sick pay, vacation, retirement or any other plan, whether or not included in a formal plan;

4. Obtain copies of all IRS determination letters and similar governmental approvals and filings for any employee benefit plans;

5. Obtain all recent actuarial reports relating to employee benefits, if applicable;

6. Obtain list of all insurance plans relating to employees of the practice;

7. Obtain list of all employment discrimination claims of the practice and/or any other employee claims or disputes against the practice for the lesser of the last five fiscal years or the number of years in practice and current fiscal year to date;

8. Obtain specific details relating to any doctor(s) formerly working in the practice since its inception; and
9. Assess feasibility and likelihood of each staff member remaining with the practice after the ownership change.

G. Litigation — Pending/Threatened

1. Obtain copies of pleadings for any pending litigation, arbitrations, grievances, other judicial or administrative proceedings;

2. Obtain list of any pending and threatened litigation since the inception of the practice relating to litigation, claims and assessments;

3. Obtain description of all outstanding judgments, assessments, penalties or fines;

4. Obtain list and copies of all demand letters, notices or claims received within the lesser of the last five years or the number of years in practice; and

5. Obtain copies of any audits performed or other governmental filings relative to the practice, including, but not limited to, ERISA and employee benefits/Department of Labor, State Dental Board, OSHA, Internal Revenue Service or State Department of Taxation since the inception of the practice.

H. Organizational Matters

1. Obtain charter and all amendments certified by the State;

2. Obtain articles of incorporation or organization certified by corporate officer or member, if applicable;

3. Obtain list of current directors and officers (or members and managers);

4. Obtain list of shareholders/members and shares/units owned;
5. Obtain current stock or membership transfer records, certificates and shares or units owned;

6. Obtain record of directors' and shareholders' (or members') actions since the inception of the practice (e.g., corporate record book); and

7. Obtain all professional annual reports for the lesser of the last five fiscal years or the number of years in practice.
Chapter 8

SELLING TO OR WORKING FOR A CORPORATE PRACTICE — THEY'RE BACK!

Several years ago, most dentists did not do well in the dental service management company (corporate practice) market through initial public offerings. In fact, some were placed in the position to reacquire their practices. Now corporate practices are back in a significant way and are organized into various forms, some very large with many locations, some small, some 100% dentist owned, some partially non-dentist owned, some only non-dentist owned and some offering venture capital opportunities. Unlike the last round, I see corporate practices in the market to stay.

Before selling your practice to a corporate practice, consider the following. First, get paid in cash. Corporate practices usually pay most of the purchase price at closing with a holdback amount to be paid in a year, based upon practice performance. If you agree to a holdback, the corporate practice will not agree for its owners to be personally liable to you. This means that there is a risk of nonpayment if the corporate practice becomes insolvent or is reacquired.

Negotiate the period of time that you would be required to work for the corporate practice and under what terms. Several years ago, the corporate practices were requiring that you work for them for five years. Now I see that time period, on average, to be two years. But if you are unhappy working for your new employer, two years can be a long time. Try to negotiate your ability to terminate your employment if you are unhappy through a notice provision, e.g., 90 or 100 days at longest. Yes, the restrictive covenant that you agreed to holds up.

Negotiate how you are paid, as well as other terms of your employment. Generally, retired general dentists working for corporate practices are paid 25% of collections and specialists, a higher percentage. Are you better off working two more years and selling to a dentist or close the doors rather than sell to a corporate practice? With the sale to the dentist, you won't be required to work for the two years and you would be paid at a much higher rate if you did. Negotiate a minimum monthly compensation rate. Also, include a provision that you will be scheduled on those days you work substantially similar to your schedule before selling your practice, ahead of any new associate hired by the corporate practice.

You really need to do your due diligence or seller homework on the corporate practice proposing to buy your practice. In a recent situation, the retired doctor wanted out of his two year commitment to the corporate practice because they paid the non-doctor staff at a significantly lower percentage of practice collections than he and his partner did. His comment
was "I cannot perform professional services at our level of quality paying the staff at a significantly reduced rate. The staff won't stay."

Make sure that you can live with the representations and warranties that you are being asked to agree to. Can you guarantee that your staff will remain with the corporate practice? Can you guarantee patients will remain or that referral sources will continue to refer? No, you cannot!

What about your building or condominium unit? Is the corporate practice willing to purchase it at closing or at some future time? The corporate practice will not provide personal guarantees and you have little security for the promise that the corporate practice will purchase your real estate at a later date. If you are leasing your facility to the corporate practice, are they granting personal guarantees as a tenant? Probably not.

Can you practice in accordance with the policies of the corporate practice? Better know about this up front.

How is the corporate practice doing financially? At what rate are they opening or buying practices and how are their practices performing?

Are you on the hook if the corporate practice relocates and spends substantial sums on a build-out, equipment and technology?

Do not invest in a corporate practice. You will have a minority interest with all the associated risks beyond your control.

Last, what about your state's dental board? Are there risks to your license by you selling your practice to corporate practice where there may be non-dentists as owners? Think states aren't looking at this? If your state's dental board is good with the sale, you and the corporate practice should have some comfort. If your state's dental board does not approve the sale, run!
Chapter 9

HIRING AND BECOMING THE ASSOCIATE

Why would an associate be hired? Because the practice owner needs someone to ease the burden of an extremely busy life, provide coverage for time-off, someone to practice with, another doctor to meet patient and/or referral demand for professional services and another doctor to buy him or her out upon retirement or other departure from practice. Will an administrative profit be made from the associate? Hopefully! Practice productivity and profitability may not be where it should to both pay the associate and earn an appropriate and administrative profit of five to fifteen percent. On top of this, the facility may not be the right square footage to accommodate the practice owner, the hygienist(s), and the associate. Additionally, the practice owner has to take time from your patients in a "one and one-half doctor" practice to mentor and train the associate/apprentice doctor.

Why would a new doctor want to become an associate? Because the new doctor may not have the ability to establish his or her own practice and have a schedule filled for a significant period of time. The new doctor will also probably lack confidence and need the mentorship of a seasoned dentist or specialist.

Do associate arrangements work? Yes. They can and should. The practice owner needs relief from stress with an associate who can truly help ease the burden of a busy practice with potential for growth. The practice owner would typically be pleased to train his or her successor knowing who will treat patients of the practice upon retirement. The practice owner also would like to know that he or she will be welcome to treat patients after "official" retirement on a limited basis, unless retirement will be complete and not partial.

Personality Profiling

From each doctor's perspective, compatibility will be a key to a successful long term relationship. In this regard, personality testing and profiling is available to assess personality types and compatibility. These testing procedures and tools are effective, inexpensive and easy to use. They are a starting point for accessing compatibility over the long term. It is tried and tested that certain personality types work well with one another and others do not. Staff personalities, and those of the doctors' spouses, are also significant to determine whether the working relationship will be successful in the practice. At a minimum, personality profiling can be a tool whereby the practice owner and associate can discuss their working relationship, philosophical values, personality types and philosophies about work.

Spouse in the Practice

The non-doctor spouse can greatly influence practice operations; the activities of the doctor(s), the operations of the practice and non-doctor staff members. The relationship between the incoming doctor, the incoming doctor's spouse, the practice owner and the practice owner's spouse is crucial, especially if the doctor's spouse is the office manager or works in the practice.
The doctor's spouse working in the practice is very common, yet the dialog between the doctors often excludes the role of the non-doctor spouse in the practice.

**Length of Association**

How long should the association last? Some associates will work on a part or full-time basis indefinitely and do not desire to own a practice. Others do desire to make their presence in the practice permanent as owners. For a specialist, the association typically lasts between one and three years. For general dentists, two to four years, with exceptions. First, the associate and practice owner must desire to practice together on a permanent basis. Further, the associate's productivity must be consistently sufficient to both earn an appropriate living for the period when the practice or practice interest is being paid for and meet the financial obligations of paying for the practice or practice interest. Therefore, the date of admitting the associate to ownership status should be based upon performance and not time.

**Associate Compensation**

Associate compensation can and should be determined in advance of the hiring process through an analysis of what the practice can afford to pay with the owner(s) making a 5% to 15% administrative profit, in light of market conditions whereby quality candidates are difficult to locate. Market conditions currently provide for relatively high compensation to both general dentists and specialists. Why? There is a shortage of incoming doctors, particularly specialty practitioners. Added to this is the increasing number of corporate practices recruiting dentists.

As an example, let's say that the incoming doctor is overpaid. Assume that the practice owner earns 40% of gross revenues as owner compensation in all forms and agrees to pay the associate 35% of production, less 35% of the corresponding laboratory costs. The associate further receives credit for hygiene examinations but not hygiene services performed by the hygienist(s) of the practice. Assume further that the practice pays the associate's malpractice insurance, one-half of individual health insurance premiums and $1,000 toward the cost of continuing education for each consecutive twelve months of the associateship. This seems like a fairly good compensation package for the associate. But how does the associate become an owner? The associate will not want to incur a reduction in pay to become an owner and there is not a sufficient spread between owner compensation in all forms and the associate's compensation to allow for future ownership. Further, the practice owner earns little, if any, administrative profit during the term of the associateship. What if the associate earns 25% of production? Then the practice owner earns an administrative profit on the associate and sufficient profit is available to allow the associate to be elevated to ownership, pay for the ownership interest and not incur a reduction in pay. This assumes that the ownership interest is paid for within an agreed upon and measured period of time, e.g., 7 years. One way to resolve this compensation problem is to pay the associate the greater of a specified base salary, not a draw, per month or the agreed percentage of "adjusted" production or collections. Adjusted production is the associate's production, less write-offs, refunds, uncollectible accounts and/or laboratory remakes. Once predetermined production levels are consistently reached, the base salary becomes irrelevant.
There is also a shortage of new doctors who choose to work full-time and own practices, which means a pool of associate doctors who will acquire your practice, in part or in whole, is shrinking. This may result in declining practice values and relatively high associate compensation in both general and specialty practices, not to mention tremendous difficulty recruiting new doctors in rural and undesirable geographic areas.

It is important to complete an analysis of what the particular practice can afford to pay, given anticipated associate revenues, the 5% to 15% administrative profit, overhead costs with the associate in place including the variable expenses of additional laboratory and supply costs, and perhaps some additional equipment and/or a chairside assistant. In short, what the practice can afford to pay an associate needs to be within its operational budget. It usually can and the associate's future ownership in a general practice is typically attributable to hygiene production, now allocated to the new owner. If the practice cannot afford the market rate for an associate, the practice owner needs to reorganize management systems in order to maximize profitability. Further, the practice owner should review the fees. This is becoming more and more difficult with reduced fee competition. After the practice becomes economically healthy, then hire the associate, at a compensation package which the practice can afford to pay. The practice owner should not be fooled into thinking that a high paid associate who takes time to train and mentor will pay a fair value for all or a portion of the practice in the future. Therefore, it is not enough just to hire the associate; the practice owner should authorize his or her advisors to complete the succession planning process, including the practice valuation and the terms, business and tax structure of the future relationship with the associate. The potential associate should expect no less of the practice owner.

What is an appropriate rate of compensation? For a general dentist, 25% to 35% of adjusted production or collections. Another way to pay the associate is 25% of adjusted production, inclusive of all hygiene services. An example of an associate compensation provision is included in Figure 9-1. For a specialist, 30% to 45% of adjusted production or collections may be an appropriate percentage and a base compensation level for certain specialties.

If the practice owner and associate agree to a "draw" against future collections, the parties, particularly the associate, should agree to a provision contained in the employment agreement that the associate does not have to repay the draw should the associate leave the practice. Similarly, if the associate is paid on collections, the employment agreement should contain a provision that collections would continue to be paid for some period of time after the employment term ends and should also provide for an "accounting" of those collections.

For specialty practices, the recruitment process is clearly regional if not national. Associate compensation packages for specialists in all cases, except prosthodontics, are high, but high associate productivity is also anticipated. The compensation is often increased each year incrementally during the associate period. There may also be a discretionary or productivity based bonus provision.
Compensation, bonuses, benefits and payment of business expenses should be specifically defined in the associate employment agreement. For example, in a general practice, the methodology for payment of laboratory expenses can be handled as indicated in Figures 9-2 A through D. Each method generates a different result. Further, it may be helpful to include any laboratory expense calculation, as well as any bonus provision calculation as an example in a schedule to the employment agreement.

In certain circumstances it may be appropriate to reduce the associate compensation by any expenses and benefits paid on behalf of the associate. This ensures that the percentage of productivity or collections remains at a quantified rate.

Bonuses are designed to economically reward work over and above the standards expected by the employer. In dental practices, bonuses usually take the form of a reward for exceeding a predetermined level of collection or productivity.

Designing a bonus formula only based upon collections or productivity is one dimensional. Consider designing associate bonuses to encourage quality of work, effort, attitude, overall performance, yet consider the cash and financial position of the practice. In short, bonuses should be discretionary for associates. The associate should benefit from such a formula in that other important criteria in addition to productivity, e.g., quality of services, are evaluated. An example of a discretionary bonus provision is included in Figure 9-3.

Because the associate period is a time of mutual evaluation for both parties, the associate can assess the fairness of the practice owner, who is often more generous than necessary. If you are the associate and you don't like the bonuses or think that the practice owner is being fair, you should leave. Practice owners should evaluate much more than productivity and inadequate performance can take many forms. Therefore, if more than production or collections will be evaluated, design an evaluation form to work from in light of the cash flow and financial position of the practice.

Proposal For Employment

Prior to the preparation of the associate employment agreement, the key terms of the employment relationship can and should be set forth in a "Proposal for Employment" letter. An example of such a letter is contained in Figure 9-4.

Associate Needs Analysis

Does the practice need and can it support an associate? If so, what is the percentage of yearly practice collections available for the associate as compensation? Can the facility support the associate to allow multiple doctors to work comfortably and effectively?

An "Associate Needs Analysis" should be completed by the practice owner and advisor(s), most notably the CPA for the practice prior to the interview. An example is included
as Figure 9-5. The Associate Needs Analysis provides that if the associate can cover all variable costs and contributes to fixed costs, hire the associate.

Assuming that the incoming doctor has completed the Qualitative and Quantitative Considerations and the practice owner has directed his or her CPA to complete the Associate Needs Analysis to determine and/or confirm that an associate should be hired, each party is ready for the interview.

**Associate Interview Questions**

The Associate Interview Questions, Figure 9-6, are applicable to both the incoming doctor and practice owner. While the Qualitative Considerations provide insight for the parties relative to what the incoming doctor wants in his or her career, the Associate Interview Questions provide guidance for a productive interview. Too often, interviews are based on whether "we like each other". While compatibility and "comfort level" are important, the 20 categories of interview questions show that there are important considerations that need to be discussed by the practice owner and incoming doctor. In short, the incoming doctor needs to answer what he or she wants in a practice. The practice owner, on the other hand, needs to know whether the practice can support an associate. The 20 categories of interview questions are designed to assist the doctors in developing a positive long-term working relationship. Quality long-term working relationships are not often attained by accident. They are designed. By asking the appropriate questions of each other after you have completed your initial homework, you will minimize the risk of a failed relationship.

**The Release Provision**

As part of the interview process, the practice owner should request that the incoming doctor sign a written release as part of the written employment application, similar to Figure 9-7. The release authorizes the practice owner to check the references of the incoming doctor; both personal and professional. If the incoming doctor has not yet practiced dentistry or his or her specialty, the professional reference check would include discussions with professors. Further, the incoming doctor should be requested to provide at least five written letters of recommendation to the practice owner. Such letters of recommendation may be from professional or personal references. The incoming doctor should also ask the practice owner for references prior to making the decision to join a particular practice.

**Succession Plan**

Unless a practice owner is planning to hire a permanent associate, the practice owner's succession plan should also be specifically defined prior to interviewing and hiring the associate. This means that the practice valuation and legal documents should be prepared in advance of the associate joining the practice. Why? Because determining practice value and preparing legal documents in advance generally reduces risk of misunderstandings. While there are significant efforts and costs involved in defining the succession plan, preparing the practice valuation and
drafting legal documents, the succession plan will be in place, irrespective of the identity of the candidate/doctor who is intended to succeed the owner(s).

The succession exit options available to the practice owner are: (a) sell the entire practice; (b) hire the associate with the obligation to sell and purchase the practice in one to three years; (c) enter into a solo group arrangement, whereby the associate acquires the goodwill attributable to the associate's developing patient base after two to three years, plus an undivided interest in the dental equipment, and where the practices thereafter operate separately under an office sharing arrangement; (d) enter into a co-ownership relationship, assuming that the practice owner intends to work for at least five more years on a full-time basis; or (e) close the door and walk away after working for one or two more years.

If the practice owner chooses to sell the complete practice or closes the door and walks away, the associate won't be hired. Similarly, if the associate will be a permanent full or part-time doctor, the incoming doctor has no need to complete any "due diligence" or purchaser homework investigation.

If the incoming doctor will play any part in the practice owner's predetermined succession plan, the associate should sign a confidentiality letter, similar to Figure 9-8. When the interview process has progressed to an advanced stage, the new doctor should commence and complete the due diligence investigation. Unfortunately, the failure to undertake and complete the due diligence investigation is a significant cause of many failed associate relationships. Think about how difficult it would be to elevate an associate to owner without the associate and practice owner having a thorough understanding of the succession plan, purchase price (or date and formula for its determination) and legal documents that delineate the business and tax structure.

**Key Employment Agreement Provisions**

Associate employment agreements alter any at-will employment relationship with the practice, whereby an employee can be fired for any reason, with or without cause. Many states have modified the employment at-will doctrine, giving employees remedies for inappropriate employer conduct.

Associate doctor relationships modify any at-will employment relationship to the extent of an associate employment agreement. So why have an associate employment agreement? Primarily, to protect the practice from dilution of value due to competition by a former associate doctor and to ensure that all parties understand their contractual obligations.

Below are the significant associate employment agreement provisions. These provisions are identical for both general dentists and specialists, except that specialists generally earn more in compensation and benefits than do general dentists and specialists are usually prohibited from soliciting both patients and referral sources. Additionally, specialists tend to become owners earlier than do general dentists. An example of an associate employment agreement for a general dentist is included as Figure 9-9.

Employment

The employment agreement should provide for the practice to offer employment and for the associate to accept the employment under the terms and conditions of the employment agreement.

The employment agreement should provide that the entire employment relationship is covered by the employment agreement itself and that in the event of a dispute, no other verbal or written evidence may be admitted to trial other than the terms of the employment agreement. This provision was a key factor in a case which was successfully litigated by my partner, Richard D. Panza, Esq., in Wall v. Firelands Radiology, Inc. [1995], 106 Ohio App.3d 313. This case involved a restrictive covenant provision, among other issues, whereby an associate physician was precluded from admitting evidence regarding the employment relationship which was not covered in the employment agreement itself.

The agreement needs to survive its term so that the restrictive covenants/nondisclosure provisions are in effect should the associate leave the practice.

The associate should promise that the associate is not currently a party to any prior employment agreements. In the event that the associate would be violating a restrictive covenant provision by joining the practice, the practice and/or the practice owner could be arguably liable to the other practice which the associate left for intentional interference with contract.

Employment Term

The employment agreement would commence on a certain date, provided that the associate is licensed to practice in the particular state. The employment term would continue until the earlier of a specified date or as provided in the employment termination provisions.

Employee's Compensation

The compensation section provides for and defines the payment of compensation and any bonuses. The obligation of the practice to pay the associate the compensation and any bonuses should be conditioned upon the associate adhering to the associate's duties and responsibilities, particularly the non-competition/non-disclosure provisions contained in the employment agreement.

There may be a signing or annual non-competition bonus, particularly if the employment term commenced prior to the associate signing the employment agreement. The signing or non-competition bonus provides for the associate's later promise not to compete as contracts need consideration on both sides. If the employment agreement is signed before the new doctor starts working, compensation and bonuses are the consideration for the non-competition/non-disclosure promises made.

Employee's Duties And Responsibilities

The duties and responsibilities section defines the associate's work schedule, full or part-time, on-call time and the authority and responsibility of the practice owner for the activities of the associate/doctor.

Employee's Non-Disclosure and Non-Competition Promises

The non-disclosure promises specifically define "confidential information" such as patient lists/referral source lists, as well as practice forms, business and development plans and computer information. The associate may not retain or disclose this information which is owned by the practice to any outside party during the term of the employment or for an agreed period of time thereafter. The associate should be required to return any confidential information to the practice in the event that the employment terminates for any reason.

The non-competition promises provide that the associate may not compete with the practice during the term of employment or for a specified period of time thereafter within a specific geographic radius. However, often a map is attached as an exhibit to the employment agreement that specifies the restricted area. Further, the associate may not, directly or indirectly, solicit patients and/or referral sources of the practice and may not hire employees of the practice for a specified period of time after the employment terminates for any reason. In those states where permitted, this section also grants a court authority to redefine the restrictive covenant provisions in the event that the court considers the restrictions too broad.

The incoming doctor may negotiate with the practice owner that the restrictive covenant not commence for some period of time, e.g., four months. Additionally, if the associate is from the geographical area where the practice is located, the associate may negotiate a buy-out of the restrictive covenant based upon the revenues generated by the associate, e.g., 37% of one year's gross revenues.

Vacation and Other Time-Off

The vacation and other time-off provisions provide for vacation time-off, with or without compensation, for each consecutive calendar year or twelve months of the employment term. The time-off may also be non-cumulative and forfeited if not taken within the applicable twelve monthly period. Further, the time-off may not interfere with the time-off anticipated by the practice owner.

Educational time-off may be granted by the employer, with or without compensation, for the associate's attendance at meetings, conventions, seminars, and/or post-graduate courses reasonably related to the associate's duties and obligations under the employment agreement, provided that the time-off is approved, in advance, by the practice.
Other time-off may be granted and paid or unpaid. Other time-off would include military reserve duty, pregnancy leave, time to study for board certifications, moving or relocation time-off, specified holidays, illness or sick days, jury duty or sabbatical time-off.

**Fringe Benefits, Expenses and Insurance**

The fringe benefits, expenses and insurance provisions provide for any fringe benefits, expenses and/or insurances, health and professional liability, either paid by the practice or the associate during each consecutive twelve month period or calendar year of the employment term. In certain circumstances, the associate's compensation may be reduced by some portion or all of the cost of the benefit, provided that federal tax laws are complied with.

**Prohibition Against Transfer**

Prohibition against transfer provides that the associate cannot assign the associate's duties and responsibilities under the employment agreement to another. Without these provisions, the associate could arguably assign the associate's non-disclosure/non-competition promises to another.

**Termination of Employment**

Termination by notice allows either the practice or associate to terminate the employment relationship with advance notice, e.g. 30, 60 or 90 days. However, if the practice terminates the employment term and does not desire for the associate to continue to render professional services, the employment agreement may provide that the associate will not permitted to continue work, subject to patient abandonment concerns, and will be paid at a predetermined rate with benefits during any notice period. If the associate is compensated as a percentage of production or collections, the notice period compensation may equal the average monthly compensation for the three succeeding months prior to the month of termination of employment. This compensation, and any benefits, for the notice period should be specifically defined in the employment agreement.

In the event of the associate's death or disability, the practice should retain the option to terminate the employment term. Disability would mean any physical or mental condition resulting from accident or illness which prevents, as determined by the practice in its sole discretion, the associate from performing the associate's then-existing duties and obligations under the employment agreement.

Breach by the associate-employee is a "for cause" termination and should grant the practice with the option to immediately terminate the employment term without notice. Such a provision may read as follows: "notwithstanding any other provision of this Agreement, Employer may immediately terminate the Employment Term at any time and without prior demand or notice if: (a) Employee fails to perform, for any reason, any of Employee's obligations, duties, promises or representations in Section 5, Section 6 or Section 9 [the non-disclosure/non-competition provisions and prohibition against transfer provisions]; or

(b) Employee commits a crime against Employer, or any of the Officers, Directors, employees, patients or agents of Employer; or (c) Employee commits any other crime, except a minor traffic violation, or any act involving fraud, dishonesty or moral turpitude; or (d) Employee fails to follow any employment directive or policy issued by Corporation." The point here is, for cause termination should be defined and negotiated by the parties to the employment agreement being signed. Item (d), for example, may include a "cure" period.

In the event that the practice breaches its promises to the associate, the associate should also have the ability to terminate the employment term without notice.

The practice would also retain the ability to terminate the employment term without notice in the event of the associate being suspended from practicing dentistry or the associate's specialty or otherwise becomes disqualified to practice dentistry or the associate's specialty in a particular state. This provision may provide that the suspension or disqualification last longer than a certain period of time period, e.g., 30 days.

Finally, the practice may retain a discretionary termination option which would terminate the employment term without prior demand or notice in the sole discretion of the practice. Such a provision is typically in effect for the first 90 to 180 days of the employment term.

**Indemnification and Contribution**

In the associate's employment agreement, the indemnification provision may read as follows: "Employee hereby indemnifies and saves Employer harmless from and against all claims, liabilities, judgments, decrees, fines, penalties, fees, amounts paid in settlement or any other costs, losses, expenses (including, but not limited to, attorneys' fees and court costs) directly or indirectly arising or resulting from or in connection or association with any threatened or pending action, suit or proceedings by third-party (whether civil, criminal, administrative, investigatory or otherwise and whether valid or not) and any appeals related thereto, under which the employee is a party or participant because of Employee's negligence or any other actions or admissions by Employee (other than willful misconduct) resulting from Employee's duties and obligations under this Agreement."

**Miscellaneous**

This section provides for the application of the laws of a particular state in the event of a dispute and provides the place where the dispute will be decided.

**Equity Purchase Provision**

This section may be included to provide that upon a specified date or earlier if invited by the practice, the associate would have the option to acquire an interest in the practice, assuming that the associate remains employed at such time. This section may provide for defined performance and quality goals to be attained by the associate prior to ownership being offered. The purchase price or appraisal prices, terms of payment and structure of transaction may be
specifically set forth. Finally, the equity provisions where co-ownership is offered should be contingent upon the associate entering into a mutually agreeable: (a) owner employment agreement; (b) close corporation, shareholder or operating agreement defining decision making control or "founder's rights" in the event of a voting deadlock or dispute; and (c) buy-sell agreement, providing for the obligation or option of the other owner(s) or practice to acquire the interest of the departing owner in the event of death, permanent disability, retirement, dispute or other termination of employment. The equity provision may also take the form of a freestanding option agreement with the corresponding practice agreements as schedules. Finally, the equity provision may be in the form of a letter of understanding, which outlines the key provisions of the contemplated ownership.

**Additional Benefits**

This optional section usually provides for the continued payment, if any, of compensation and coverage of benefits for some period of time in the event of death or permanent disability, typically until the disability income replacement insurance is in effect. At times, there may be continued payment of compensation in the event of temporary disability. These payments are typically offset by any disability insurance benefit. In certain circumstances, there may be a period of severance pay which is often conditioned upon certain events, e.g., the departing specialist practicing in California not competing with the practice.

**Anticipating Ownership**

When is ownership discussed? The earlier the better. To the extent that the parties discuss and determine the fair market value of the practice and the date it is recalculated, the interest being acquired — a complete or partial interest in the practice, the payment terms, the structure of the transaction, the future obligation or option to buy-out any existing owner(s), the less chance there is for future misunderstanding on these complex matters. This process should be weighed against the economic cost of preceding earlier, rather than at a later predetermined date, after the associate relationship has commenced.

**Independent Contractor Status**

Most associates do not qualify under either applicable state or federal laws as independent contractors. The criteria to determine independent contractor status was set forth in Revenue Ruling 87-41 and the factors are now included in three broad areas contained in Figure 9-10. In reading through the twenty criteria to determine independent contractor status, you may find that any associate which you have classified as an independent contractor is in reality an employee. This means that the associate should be classified and paid as an employee with applicable taxes taken out of compensation. Some practices have attempted to pay associate doctors as independent contractors to avoid the employer's portion of payroll taxes. This conduct can pose a significant risk to the practice. If the practice owner is going to err on worker classification status, err on the side of classifying the doctor as an employee.
Joining And Leaving The Dental Practice

Hiring And Becoming The Associate

Second Edition


An example of an independent contractor may be an orthodontist rendering professional services in a pediatric dentist's practice two days or a week or an endodontist providing professional services in a general practice on certain days and times.

The doctor who sells his or her practice and then provides services on behalf of the purchasing doctor may or may not qualify as an independent contractor. The specific relationship and circumstances should be reviewed on a case-by-case basis to determine proper worker classification.

Associate doctors should be concerned of indemnifying or holding harmless the senior doctor's practice in the event that the associate is classified as an independent contractor. Many independent contractor agreements, similar to associate employment agreements, provide that the associate would hold harmless or indemnify the practice for any costs or penalties relative to the practice's misclassification of the associate as a worker. The bottom line is that most associate doctors are employees, not independent contractors. One method of justifying an independent contractor relationship is whereby the associate doctor charges the patients for treatment and pays the practice an agreed amount for use of the premises.

Practice owners should note that the enforcement of non-competition provisions may be difficult where the associate is classified as an independent contractor rather than as an employee. If you, as practice owner, are concerned with the associate competing in the event that the associate leaves your practice, classify the associate as an employee and not an independent contractor.

**Buy-Sell Agreements**

The practice owner may consider a buy-sell agreement for the associate in the event of death or permanent disability. In short, if the practice owner dies or becomes permanently disabled, the associate buys the practice. Insurance should be considered as a funding mechanism, subject to health, costs and availability. In the event of a catastrophe, the practice owner and his or her family members won't have to negotiate the sale of the practice under adverse circumstances. From the associate's prospective, he or she should understand that the deceased or permanently disabled doctor's practice won't be sold to another.

In the event that the association is unsuccessful, the associate leaves and he starts over. From the associate's perspective, confidence and time are lost. Both the practice owner and the associate have much to lose by the associateship not working. Therefore, it is in everyone's interest to do all possible to ensure the long term success of the working relationship.
ASSOCIATE COMPENSATION

For each consecutive month of the Employment Term, Corporation shall pay Employee a basic salary (the "Basic Salary") equal to the greater of: (a) ________Dollars ($_________); or (b) thirty percent (30%) of Adjusted Production (as herein defined) attributable to professional dental services rendered to Corporation's Patients (as herein defined) inclusive of hygiene examination fees and excluding hygiene services performed by Corporation's hygienist(s). The Basic Salary shall be paid in at least monthly installments during Corporation's usual and customary pay periods and shall be prorated (on a daily basis) if the Employment Term terminates prior to the completion of any monthly period. For purposes of this Agreement, Adjusted Production means Employee's rendering of professional dental services hereunder, less dental laboratory remakes, refunds, uncollectible accounts, write-offs, discounts and reduced fee plans of any nature. Notwithstanding the foregoing, Employee's Basic Salary and any Bonuses (as herein defined) shall be reduced and off-set by the full cost of any benefits and business expenses under Section ____ and any retirement plan contributions made by Corporation on Employee's behalf under Section ____.
### Figure 9-2

#### EFFECT OF DENTAL LABORATORY COSTS ON ASSOCIATE COMPENSATION

#### Figure 9-2A

**Production, Less Percentage Lab, Times Percentage**

1. Monthly Associate Production: ................................................................. $30,000
2. Less, 1/3 Dental Laboratory Costs Attributable To Associate
   \((10\% \times .33 = $3,000 \times .33 = $1,000)\): .......................................................... \(<$ 990>\)
3. Subtotal: ....................................................................................................... \($ 29,010\)
4. Compensation Percentage: ........................................................................... \(x \ 33\%\)
5. Monthly Associate Compensation: ............................................................. \($ 9,573\)

#### Figure 9-2B

**Production, Times Percentage, Less Percentage Lab**

1. Monthly Associate Production: ................................................................. $30,000
2. Compensation Percentage \(x \ 33\%\)
3. Subtotal: ....................................................................................................... \($ 9,900\)
4. Less, 1/3 Dental Laboratory Costs: ............................................................. \(<$ 990>\)
5. Monthly Associate Compensation: ............................................................. \($ 8,910\)

#### Figure 9-2C

**Production, Times Percentage**

1. Monthly Associate Production: ................................................................. $30,000
2. Compensation Percentage \(x \ 30\%\)
3. Subtotal: ....................................................................................................... \($ 9,900\)

#### Figure 9-2D

**Production, Less 1/2 Lab, Times Higher Percentage**

1. Monthly Associate Production: ................................................................. $30,000
2. Less, 1/2 Dental Laboratory Costs: ............................................................. \(<$ 1,500>\)
3. Subtotal: ....................................................................................................... \($ 28,500\)
4. Compensation Percentage: ........................................................................... \(x \ 35\%\)
5. Monthly Associate Compensation: ............................................................. \($ 9,975\)
**Figure 9-3**

**BONUS(ES)**

**(OPTIONAL)**

In its sole discretion, Corporation may, but should not be obligated to, pay Employee a bonus(es) (collectively the "Bonus"). Any Bonus hereunder shall be based upon Employee's overall contribution to Corporation's dental practice, including, but not limited to, Employee's attitude, effort, quality of clinical care, relationships with Patients and staff, productivity and punctuality, and shall further be based upon Corporation's general cash and financial position.
Figure 9-4

PROPOSAL FOR EMPLOYMENT

DRS. SMITH & JONES, INC.

[Insert Address]

August 1, ______

Dr. Thomas R. Roberts
[Insert Address]

RE: Proposal for Employment

Dear Tom:

Dr. Smith and I would be very pleased to have you join Drs. Smith & Jones, Inc. (the "Corporation") as a full-time periodontist on or approximately January 1, ______, pursuant to the proposal described herein.

I. Term of Employment. Your employment as an associate periodontist with the Corporation would be for a term, not to exceed three (3) years and based upon your production that must exceed $575,000.00 over a twelve (12) consecutive month period, the "Agreement Term". During such time, the Corporation, its shareholders and you would have the opportunity to mutually evaluate our working relationship and the prospect of working together as shareholders of the Corporation over the long term.

II. Ownership Interest. After completion of the Agreement Term, you would be provided the opportunity to purchase a number of shares of the Corporation's issued and outstanding common stock equal to that of any other shareholder, presumably one-third (1/3) of the issued and outstanding shares. The purchase of your shares in the Corporation would be subject to the preparation of documents mutually acceptable to you and the Corporation.

III. Compensation as an Employee/Periodontist. You would be paid compensation as follows:

(a) For the first year of the Agreement Term, you would be paid a salary of $150,000.00; and

(b) For the second year of the Agreement Term, you would be paid a salary of $175,000.00.

Additionally, you would be eligible for a discretionary bonus payable prior to the end of each calendar year of the Agreement Term, which would be based upon your total contribution to the Corporation's periodontal practice and further based upon the Corporation's cash and financial position.

IV. Benefits Paid on your Behalf. In addition to your salary, the Corporation would pay the reasonable cost of benefits on your behalf, which would be substantially similar to those of its
current periodontist/employees, dependent upon economic and market conditions. Such benefits presently include the payment of:

(a) Liability insurance premiums;
(b) Family hospitalization insurance premiums;
(c) Disability insurance premiums;
(d) Continuing education costs and associated travel expenses, approved in advance by the Corporation;
(e) Entertainment expenses;
(f) Dues and membership fees; and
(g) Retirement plan contributions (in accordance with the eligibility provisions of the Corporation's profit-sharing plan).

V. Time Off. You would receive three (3) weeks of vacation for each year of the Agreement Term. Additionally, you would receive holidays off and receive certain days off for attendance at continuing education courses.

VI. Expenditure of Time. The position which the Corporation is offering to you requires your full-time efforts. You would be expected to work on a full-time basis in accordance with the Corporation's usual scheduling policies. However, there would be times which you would be expected (during the day, evenings and weekends) to develop referring relationships with general dentists through various non-clinical marketing activities.

VII. Employment Agreement. Provided that you accept the terms of the proposed employment with the Corporation as outlined herein, you would be asked to sign an employment agreement. The employment agreement would be presented to you in the near future for your and your legal counsel's review. The employment agreement would contain provisions relating to your compensation, fringe benefits, non-competition/non-disclosure, termination and responsibilities.

VIII. Termination of Employment. It is the intention of the Corporation's current shareholders that you become a shareholder within three (3) years. However, in the event that the working relationship between you and the Corporation would ever become unacceptable, either to you or the Corporation for any reason, a provision contained in your employment agreement would provide for termination by either party, upon the expiration of thirty (30) days written notice.

IX. Purchase Price. The purchase price for the shares in the Corporation which you would purchase would equal the fair market value of such shares as a percentage of all of the issued and outstanding common shares of the Corporation. Our recent appraisal indicates that the fair market value of the Corporation is $900,000.00 and has been reduced to reflect that you are purchasing stock in after-tax dollars. Therefore, the purchase price for one-third (1/3) of the
issued and outstanding shares would equal $300,000.00 as of the date you become an owner of the Corporation (the "Buy-In").

X. Payment of the Purchase Price. The purchase price for the Buy-In would be paid as follows: (a) twenty-five percent (25%) of the purchase price would be paid pursuant to a cash down payment; and (b) the remaining seventy-five percent (75%) of the purchase price would be financed by the Corporation and paid over seven (7) years, at two percent (2%) less than the prime rate of interest then charged by the Corporation's bank.

XI. Operational Control. As an owner of the Corporation, you would share a voice in its operation and control equal to that of any other shareholder.

XII. Non-Binding Proposal. This proposal is not intended to create or impose any legally binding obligations on the part of you, the Corporation or its shareholders. The consummation of the proposal contained herein is expressly conditioned upon and subject to the execution of definitive legal documents, which legal documents must be in form and substance satisfactory to you, the Corporation and our respective legal counsel.

Please carefully review the foregoing with your legal counsel and call me with any questions which you may have relative to this matter. Thereafter, if the terms and conditions described herein meet with your and your legal counsel's approvals, please sign and date below where indicated and return a signed copy of this letter to me in the pre-addressed, stamped envelope on or before August 15, ______. Upon my receipt of the signed copy of this letter, I will request that the Corporation's legal counsel commence preparation of your employment agreement in "draft" version.

Dr. Smith and I look forward to your joining the Corporation as an periodontist in the near future.

Sincerely yours,

DRS. SMITH & JONES, INC.

INSTRUCTIONAL USE — DO NOT SIGN

By: Dr. Joseph G. Jones, President

I have read this letter carefully and accept the terms and conditions stated herein.

______________________________
Date

Dr. Thomas R. Roberts

INSTRUCTIONAL USE — DO NOT SIGN

ASSOCIATE NEEDS ANALYSIS

A. Assumptions

1. Associate Will Work Full-Time — 32 Hours Per Week and Will Earn the Greater of $120,000 (Includes Payroll Taxes and Benefits) Per Year or 30% of Adjusted Production, Including Hygiene Exam Fees, But Not X-Rays or Hygiene Services.

2. Assistant Will Cost $35,000 Per Year, Inclusive of Compensation, Payroll Taxes and Benefits.

3. Additional Equipment, Remodeling, Supply and Laboratory Costs, Payable Over 7 Years, Inclusive of Interest of $10,000.

4. Marketing and Advertising Costs of $10,000

B. Costs and Required Collections

1. Associate ................................................................. $ 120,000
2. Assistant ................................................................. $ 35,000
3. Capital Expenditures, Supplies and Lab: ......................... $ 10,000
4. Marketing and Advertising Costs ................................. $ 10,000
5. Estimated Yearly Associate Cost ................................. $ 175,000
6. Divided by 12 Months ............................................. $ 14,583

C. Analysis

1. Practice Should Earn a 10 - 15% Administrative Profit On the Associate.


3. How Many Active Patients Are There in the Practice?

4. Why is the Associate Being Hired?

5. Note, $120,000 is 30% of $400,000.

6. Business Rule — If Variable Costs are Covered and Associate Contributes to Fixed Costs, the Decision to Hire is Economically Sound.
ASSOCIATE INTERVIEW QUESTIONS

1. **Mission and Philosophy**
   
   What is the mission, philosophy and clinical quality standards of the practice?

2. **Goals**
   
   Do we share similar goals for clinical excellence, leadership, practice growth and learning the business of dentistry?

3. **Facility Design**
   
   How is the practice facility designed and what are the spatial limitations, if any? —Is the facility clean? —How many treatment rooms are there and how many hygienist(s) work in the practice? Who will work where as compared to current scheduling practices?

4. **Compatibility**
   
   What type of person do I want to associate with and will patients and/or referral sources, as well as staff accept me? How do I give my patients away? Will we be compatible on both the professional and personal levels?

5. **Personality Profiling**
   
   Will we use personality profiling testing to assess our compatibility? —If not, how will we evaluate each other? —At what point in the interview process will the non-doctor spouses meet?

6. **Practice Systems**
   
   How are the systems of the practice managed? A partial list of the systems that should be managed are described in Attachment 8.

7. **Professional Services Performed/Collections**
   
   What procedures and services does the practice owner perform and what procedures are referred? What procedures and services will the incoming doctor perform? —How are the services performed paid for and what is the collection policy and rate of the practice?
8. Work Schedule/Patient Assignment

What is the work schedule for the practice owner (days and hours)? What is the anticipated work schedule for the associate (days and hours) and how will patient assignments be made? —What kind of patients will be treated by the associate? —Inspect and discuss the appointment book! —Is the practice overbooked and do patients wait?

9. Internal and External Marketing

What is the internal and external marketing policy of the practice? What are the internal and external marketing expectations for the incoming doctor?

10. Coverage/On-Call

What are the office coverage "on-call" expectations for the incoming doctor and practice owner? How many emergencies occur on a monthly basis?

11. Mentoring

How will the clinical and administrative mentoring process take place?

12. Productivity

What are the productivity and revenue expectations for the incoming doctor?

13. Compensation

How will the incoming doctor compensation package be structured?

14. Benefits and Expenses

What benefits and expenses will be paid through the practice versus the incoming doctor?

15. Staff Interview

What point in the interview process will the staff be introduced to the incoming doctor?

16. Roll of Non-Doctor Spouse and Other Family Members

What is the role of the non-doctor spouse and other family members in the practice?
17. **Restrictive Covenants/Termination of Employment**

What are the restrictive covenants and termination of employment provisions in the event that the working arrangement fails?

18. **Associate Employment Agreement**

At what point of the interview process will the incoming doctor be presented with an associate employment agreement and what are the terms? —Note, the incoming doctor is probably not an independent contractor.

19. **Associate and Future Relationship**

What is the length of the associate relationship and what are the specific objectives for the future working relationship?

20. **Purchaser Due Diligence-Succession Planning Documents or Proposal for Ownership**

After signing a confidentiality letter, how will the incoming doctor evaluate the specific objectives for the future working relationship in light of cash flow and debt of the practice, practice valuation and succession plan documents. See the Due Diligence Checklist is described in Attachment 6. Certain of the items in Attachment 6 should be requested to be reviewed or used as part of the preparation or confirmation of the practice valuation.
JOB APPLICATION RELEASE PROVISION

I certify that the information presented in this Application is true and complete. I understand that, if hired, my continued employment is expressly conditioned upon the accuracy and completeness of the information I have provided. If I am offered, and I accept, employment, I agree to abide by all rules, regulations and policies which the company may institute from time to time, in its discretion.

I understand that this Application, copies of rules, regulations and policies, and any other company documents, are not contracts of employment, and that either I or the company may terminate my employment at any time, for any reason, or no reason. No representative of the company has made any oral or written statements to the contrary and I have not relied on any oral or written statements by a company representative regarding any employment hereunder.

I authorize the company to contact any of the schools, colleges, employers, and references which I have listed on this Application, as well as any other persons or institutions, and to inquire about my suitability and qualifications for employment with the company. In consideration for the opportunity to submit this application, I agree to indemnify and save harmless the company, all the aforementioned schools, colleges, employers and references, and any other person or institution contacted by the company with respect to this Application, from and against all liabilities, costs, expenses (including attorney fees), charges, claims, fines, actions, causes of action directly or indirectly related to this Application and the company's acceptance or the rejection of the Application. A copy of this authorization and release shall be considered the same as the original.
CONFIDENTIALITY LETTER

[INSERT DATE]

PERSONAL AND CONFIDENTIAL

[Insert Name]
[Insert Address]

RE: Confidentiality Letter

Dear [Insert Name]:

You have expressed an interest in acquiring my dental practice (herein called the "Practice"). As such, you will request and I will disclose to you and your advisors certain financial, tax and operational information regarding the Practice, as well as certain of my personal financial information (herein collectively called the "Confidential Information").

In consideration of my release of the Confidential Information, you agree that: (i) the Confidential Information shall (at all times) be and remain my exclusive property; and (ii) you shall hold the Confidential Information as a trustee and fiduciary for me; and (iii) you shall use the Confidential Information solely and exclusively for the purpose of evaluating the potential acquisition of the Practice. Notwithstanding the foregoing, you are permitted to share the Confidential Information with your advisors.

If negotiations between you and I terminate (for any reason) without the consummation of your acquisition of the Practice, you shall promptly return all Confidential Information to me.

If the terms and conditions of this letter are acceptable, please so indicate by signing and dating the enclosed copy of this letter where indicated on page 2, and return the signed copy to me in the self-addressed, stamped envelope. Thereafter, my advisors will provide you and your advisors with any and all reasonable requests for information, including recent financial statements and Federal Income Tax Returns for the Practice.

I look forward to working with you.

Sincerely yours,

[Insert Name]

I have read this letter carefully concerning the terms and conditions of the Confidential Information, and accept the same as stated herein above.

Date: [Insert Name]
EMPLOYMENT AGREEMENT

FOR xx[________________________, DDS/DMD]xx

This Employment Agreement (the "Agreement"), made at __________________, ____________________, as of this _____ day of _______________, 20_____, by and between xx[Company]xx, which with its successors and assigns is herein called "Company", and xx[________________________, DDS/DMD]xx, who is herein called "Employee", is to EVIDENCE THAT in consideration of the mutual promises made in this Agreement, Company and Employee (collectively, the "Parties" and individually a "Party") agree as follows:

1. Employment.

1.1 Offer and Acceptance of Employment. Upon the terms and conditions stated in this Agreement and in reliance upon Employee's promises made in this Agreement, Company hereby offers to employ Employee as an "employee at will" under __________________ law and Employee hereby accepts such employment with Company.

1.2 Entire Agreement Covering Employment. This Agreement represents the entire agreement between Employee and Company regarding Employee's employment with Company. All prior or contemporaneous written or verbal statements, negotiations, representations, arrangements and/or agreements regarding Employee's employment with Company are merged into and superseded by this Agreement. Both Parties acknowledge that there are no verbal or other written understandings, arrangements, commitments, and/or agreements between the Parties regarding Employee's employment with Company. Employee acknowledges that, as an inducement to sign and perform under this Agreement, Employee has not relied upon any promises, statements or representations of Company which are not expressly stated in this Agreement.

1.3 Changes to Agreement. Except as otherwise expressly stated herein, this Agreement may be changed or amended only by a written document which is clearly designated as an amendment to this specific Agreement and only if such written document is signed by a representative of Company so authorized to sign and by Employee.

1.4 Waiver of Agreement Provisions. No course of action by either Party and no refusal or neglect of either Party to exercise a right granted under this Agreement or to enforce compliance with any provision of this Agreement shall constitute a waiver of any provision of or any right under this Agreement, unless such waiver is expressed in a written document which is clearly designated as a waiver of a specific provision(s) of this Agreement and unless such document is signed by the waiving Party.
1.5 **Survival of Agreement.** All provisions of this Agreement are severable and neither this Agreement nor any provision hereof shall be affected by the invalidity or unenforceability of any other provision of this Agreement.

1.6 **Prior Agreements.** Employee represents that, upon commencement of the Employment Term, Employee: (a) is not bound by any employment, independent contractor, non-disclosure, non-competition or similar agreement or arrangement which restricts Employee from signing this Agreement or from performing the duties and obligations assigned to Employee under this Agreement, and (b) has not unlawfully or improperly appropriated or removed any confidential or proprietary information, documents or trade secrets of any third-party.

2. **Term.** The term of this Agreement (the "Employment Term") shall commence on the ____ day of ___________________, 20_____, and shall continue until terminated as herein provided.

**(Option A)**

3. **Employee's Compensation.** During the Employment Term, Company shall pay Employee a basic salary (herein called the "Basic Salary") equal to _______________ Dollars ($_________) per "Work Day". For purposes of this Agreement, a Work Day means Employee being available for work at one of Company's practice facilities where Employee is scheduled during Company's usual and customary hours of business, not to exceed eight (8) hours per Work Day unless otherwise mutually agreed to by the Parties. The Basic Salary shall be payable during Company's usual and customary payroll periods, and shall be prorated (on a daily basis) if the Employment Term terminates prior to the completion of any monthly period. Notwithstanding the foregoing, Employee's Basic Salary shall be reduced and offset by Employee's portion of any reasonable and necessary business expenses (approved in advance by Company) under Section(s) _____ herein.

**(Option B)**

3. **Employee's Compensation.** During the Employment Term, Company shall pay Employee a monthly basic salary (the "Basic Salary") equal to the greater of:
   (a) __________________ Dollars ($__________); or (b) _____________ percent (____%) of collections xx[Adjusted Production (as herein defined)]xx attributable to professional dental xx[specialty]xx services rendered by Employee to Company's Patients (as herein defined), including hygiene examinations performed by Employee and excluding x-rays and hygiene services performed by Company's hygienists. xx[For purposes of this Agreement, Adjusted Production means Employee's production hereunder, less Patient refunds, write-offs, reduced fees, uncollectible accounts and laboratory remakes.]xx

4. **Employee's Duties and Responsibilities.**

   4.1 **Professional Duties and Responsibilities.** During the Employment Term, Employee will: (a) at all times deal faithfully with Company and its employees, Patients, xx[referral sources]xx and agents; and (b) perform all professional duties and responsibilities related
Joining And Leaving The Dental Practice
Hiring And Becoming The Associate
Second Edition

Figure 9-9

to the practice of dentistry xx[specialty]xx as are periodically assigned to Employee by an authorized agent of Company in accordance with the directives, policies and instructions of Company (whether written or verbal) and the standards designated in Sections 4.2, 4.3 and 4.4 to the satisfaction of Company in its sole discretion (provided, however, that Company shall not exercise control over Employee's professional clinical judgment). Employee's duties and responsibilities are personal in nature and, without Company's prior written consent, may not be assigned or transferred to any other person or entity.

4.2 **Expenditure of Time.** While rendering professional dental xx[specialty]xx services on behalf of Company during the Employment Term, Employee shall devote Employee's best efforts, skill, labor, expertise and attention to the practice of dentistry xx[specialty]xx, xx[exclusively]xx for Company and to performing Employee's duties and obligations assigned to Employee under this Agreement and, at all times, shall faithfully and diligently serve and further the best interests of Company. Employee shall be scheduled not less than an average of four (4) Work Days per week, except for Employee's vacation and other time-off as designated in Section 7 hereunder.

4.3 **Professional and Ethical Standards.** Employee represents that Employee holds a valid, current and unrestricted license to practice dentistry xx[specialty]xx in the State of ______________ and has training and experience in the profession of dentistry xx[specialty]xx. Employee promises that Employee shall perform all Employee's professional duties hereunder and shall render all dental xx[specialty]xx services hereunder in accordance with the highest professional, legal and ethical standards periodically established for Employee's profession.

4.4 **Authority of Company.** Company shall have the following authority: (a) to determine the assignment of Patients to Employee and to require Employee to perform general or specific services for the Patients so assigned to Employee; and (b) to review, modify and redo all professional dental xx[specialty]xx services rendered by Employee; and (c) to retain final authority over acceptance or refusal of any Patients and over the amount of fees to be charged to any Patient for professional dental xx[specialty]xx services rendered by Employee; and (d) to direct and supervise Employee's professional services rendered hereunder and the manner and time for performing such professional services (provided, however, that Company shall not exercise control over Employee's professional clinical judgment).

4.5 **Accounting for Professional Services.** As Company may periodically request, Employee shall forthwith render a complete and accurate accounting of all transactions relating to Employee's practice as a dentist xx[specialist]xx during the Employment Term.

5. **Employee's Non-Disclosure and Non-Competition Promises.**

5.1 **Definitions.** For purposes of this Agreement, the Parties agree to and understand the following definitions:

(a) "Competitive Act" means any of the following: (i) Employee's rendering of professional dental xx[specialty]xx services (whether
Figure 9-9

or not for compensation) to, for or on behalf of a Competitor (as defined herein) as an employee, independent contractor, consultant, advisor, representative, agent or in any other capacity; and (ii) Employee's investment in or ownership (partial or total) of a Competitor, unless the Competitor's stock is publicly traded on a national exchange and Employee owns less than two percent (2%) of such stock.

(b) "Competitive Activity" means the performance or rendering of any professional dental services which competes with the professional dental services of Company.

(c) "Competitor" means any of the following: (i) any person, sole proprietorship, partnership, association, organization, corporation (other than Company), limited liability company or other entity (governmental or otherwise) who or which provides, renders or performs a Competitive Activity (as defined herein) within the Service Area (as defined herein), even if the Competitor has no office or other facilities located within the Service Area; and (ii) any parent, subsidiary or other person or entity affiliated with, or related by ownership to, any of the foregoing designated in Subitem (i) of this Section 5.1(c).

(d) "Confidential Information" means all of the following (whether written or verbal) pertaining to Company: trade secrets (as defined by law); Patient lists, records and other information regarding Company's Patients (whether or not evidenced in writing); Patient fee schedules and fee policies; financial books, plans, records, ledgers and information; purchase orders, agreements and related data; business and practice development plans; sales and marketing plans; research and development plans; employment and personnel manuals, records, data and policies; business and practice manuals, methods and operations; business and practice forms, practice correspondence, memoranda and other records; know-how; computer records and related data; and any other confidential or proprietary data and information of Company or its Patients which Employee encounters during the Employment Term.

(e) "Patient" means a person, sole proprietorship, partnership, association, organization, corporation, limited liability company, insurance company, health maintenance organization, preferred provider organization, other managed care organization, or other entity (governmental or otherwise), wherever located: (i) to or for which Company renders or performs (or may render or perform
under a capitation or similar contract) professional dental specialty services either during the 180-day period immediately preceding commencement of the Restricted Period or during the Restricted Period, or (ii) which Company solicits or (as demonstrated by plans, strategies or other tangible preparation) intends to solicit to purchase professional services from Company either during the 180-day period immediately preceding commencement of the Restricted Period or during the Restricted Period.

(f) "Restricted Period" means a period of _____ (_____) years commencing on the date the Employment Term is terminated by either Party (for any reason, with or without cause); provided, however, that such period shall be extended to include any period of time during which Employee engages in any activity constituting a breach of this Agreement and any period of time during which litigation transpires wherein Employee is held to have breached this Agreement.

(g) "Service Area" means the map attached as Schedule A (attached hereto and incorporated herein by reference) miles in all directions from Company's dental practice facility located in , constituting those geographic areas in which Company presently conducts (and plans to conduct) substantial business and professional activities.

5.2 Employee's Promises. Expressly in consideration for the covenants made by Company in this Agreement, especially the Basic Salary in Section 3, Employee promises and agrees that:

(a) Confidentiality. The Confidential Information is and, at all times, shall remain the exclusive property of Company, and Employee: (i) shall hold the Confidential Information in strictest confidence and in a position of trust for Company and its Patients, and (ii) except as may be necessary to perform Employee's employment duties hereunder, shall not (directly or indirectly) use for any purpose, copy, duplicate, disclose, convey to any third-party or convert any Confidential Information, either during the Employment Term or at any time following termination of the Employment Term (by any Party, for any reason, with or without cause), and (iii) upon the request of Company at any time during or after the Employment Term, shall immediately deliver to Company all the Confidential Information in Employee's possession and
shall neither convey to any third-party nor retain any copies or duplicates thereof; and

(b) Competitive Acts. Without Company's express written authorization during the Employment Term and during the Restricted Period, Employee (or any entity owned or controlled by Employee) shall not directly or indirectly, without the prior written approval of an authorized representative of Company, perform a Competitive Act; and

c) Patients xx[and Referral Sources]xx. During the Restricted Period, Employee (or any entity owned or controlled by Employee) shall not directly or indirectly: (i) solicit from or perform for any Patient xx[or referral source]xx a Competitive Activity, wherever such Patient xx[or referral source]xx is located or (ii) influence (or attempt to influence) any Patient xx[or referral source]xx to transfer such Patient's patronage or business from Company, or (iii) otherwise interfere with any business or professional relationship of Company with any Patient xx[or referral source]xx; and

d) Employees. During the Restricted Period, Employee (or any entity owned or controlled by Employee) shall not directly or indirectly: (i) employ, engage, contract for the services of, or solicit or otherwise induce the services of any person who, during the one hundred eighty (180)-day period immediately preceding commencement of the Restricted Period or during the Restricted Period, is or was an employee of Company, or (ii) otherwise interfere with (or attempt to interfere with) any employment relationship of Company with any employee of Company; and

e) Costs of Enforcement. Employee shall pay all reasonable legal fees, court costs, expert fees, investigation costs, and other expenses incurred by Company in the enforcement of this Section 5.

5.3 Importance of Employee's Promises. Employee understands and agrees that:

(a) During the Employment Term, Employee will materially assist Company in the generation, development or enhancement of certain Confidential Information, Patients xx[and referral sources]xx and certain other business and professional assets and activities for Company; and
Figure 9-9

(b) Employee's promises in this Section 5: (1) were negotiated at arm's-length and with ample time for Employee to seek the advice of legal counsel, (2) are required for the fair and reasonable protection of Company and the Confidential Information, and (3) do not constitute an unreasonable hardship to Employee in working for Company or in subsequently earning a livelihood in Employee's profession outside the Service Area; and

(c) If Employee breaches (or threatens to breach) any or all of the promises in this Section 5: the secrecy and thereby the value of the Confidential Information will be significantly jeopardized; Company will be subject to the immediate risk of material, immeasurable, and irreparable damage and harm; the remedies at law for Employee's breach shall be inadequate; Company shall therefore be entitled to injunctive relief against Employee in addition to any and all other legal or equitable remedies; and

(d) If Employee had not agreed to the restrictive promises in this Section 5, Company would not have employed Employee under the terms and conditions of this Agreement and would not have signed this Agreement.

5.4 Continuation of Employee's Promises. Employee's promises, duties and obligations made in this Section 5 shall survive the voluntary or involuntary cessation or termination of the Employment Term by either Party (for any reason, with or without cause). If any of the restrictions contained in this Section 5 are ever judicially held to exceed the geographic or time limitations permitted by law, then such restrictions shall be deemed to be reformed to comply with the maximum geographic and time limitations permitted by law. The existence of any claim or cause of action by Employee against Company (whether or not derived from or based upon this Agreement) shall not constitute a defense to Company's enforcement of any covenant, duty or obligation of Employee in this Section 5.


6.1 Malpractice Insurance. During the Employment Term, Company shall obtain and pay for the cost of professional malpractice insurance for Employee's professional duties hereunder substantially similar to Company's other dentist xx[specialist]xx-employees.

6.2 Health Insurance Premiums. During the Employment Term, Company shall pay the full cost of individual health insurance premiums on behalf of Employee and Employee shall pay the additional cost of any dependent and/or family premiums. Company's payment of Employee's health insurance premiums hereunder shall be in accordance with the terms, conditions, eligibility requirements and benefits under Company's Medical-Hospitalization Insurance Plan as periodically amended by Company and shall be substantially similar to Company's Medical-Hospitalization Insurance Plan in effect as of the date of this Agreement.

6.3 **Continuing Education Tuition Costs.** During the Employment Term, Company shall pay Employee's continuing education tuition costs (not to exceed $__________ in any 12-month period) for those courses reasonably related to Employee's profession and duties and responsibilities hereunder; provided, however that the costs of such continuing education courses must be approved (in advance) by Company.

6.4 **Dues.** During the Employment Term, Company shall pay for or reimburse Employee for the cost of such annual dues as Company determines in its sole discretion, including, but not limited to, ADA, _________ and local component membership dues in dentistry ______. [specialty]

6.5 **Retirement Plan(s).** During the Employment Term, Employee shall participate in Company's retirement plan(s) in accordance with the terms, eligibility requirements and benefits as periodically determined and amended by Company in its sole discretion.

6.6 **State [Specialty] Board Examination.** Assuming that Employee is employed by Company when Employee takes the [State] [Specialty] Board Examination (herein called the "Exam"), Company shall pay or reimburse Employee the fee for the Exam in an amount equal to _________________________ Dollars ($__________). [specialty]

6.7 **Expenses.** In addition to the insurances, benefits and expenses described in Sections 6.1 through 6.6 herein, during the Employment Term and in accordance with Company's general expense reimbursement programs and policies (as may be periodically amended or terminated by Company), Company shall pay or reimburse Employee for all reasonable and necessary business expenses (not to exceed _________________________ Dollars ($__________) in any monthly period) incurred by Employee in the performance of Employee's duties and obligations as an employee under this Agreement; provided, however, that such business expenses must be approved (in advance) by Company. Notwithstanding the foregoing, any reasonable and necessary business expenses above _________________________ Dollars ($__________) in any monthly period (approved in advance by Company) shall be reduced and offset from Employee's Basic Salary under Section 3 herein.

7. **Vacations and Other Time-Off.**

7.1 **Vacations.** During each twelve (12) consecutive months of the Employment Term, Employee shall be entitled to _____ (____) weeks of vacation time-off, without any Basic Salary, at times approved (in advance) by Company; provided, however, that: (a) without Company's prior approval, all vacation time-off shall be non-cumulative and will be forfeited if not taken during the appropriate twelve (12) consecutive monthly period of the Employment Term; and (b) if the Employment Term terminates prior to completion of any such twelve (12) consecutive monthly period of the Employment Term, the vacation time-off to which Employee is entitled hereunder shall be prorated in the same proportion that the number of complete months Employee actually worked during such twelve (12)-month period bears to twelve (12) months; and (c) Employee shall not be entitled to any vacation time-off during the first six (6) months of the Employment Term. Employee's annual vacation time-off shall be
increased in accordance with Company's general vacation policy as may be periodically amended by Company in its sole discretion.

7.2 Educational Time-Off. During each twelve (12) consecutive months of the Employment Term, Employee shall be entitled to _______ (______) additional days of time-off, with full Basic Salary, for attendance at meetings, conventions, seminars, and/or postgraduate courses reasonably related to Employee's professional and other duties and obligations hereunder; provided, however, that such meetings, conventions, seminars and courses must be approved (in advance) by Company.

8. Conditions to Company's Obligations. The obligations of Company to pay Employee's Basic Salary under Section 3, or to provide any of the benefits designated in Section 6 are expressly conditioned upon Employee's performance of and adherence to each and every promise, duty and obligation assigned to or made by Employee under this Agreement (including, but not limited to, Employee's promises in Section 5).


9.1 Termination by Notice. In addition to termination under any other provision of this Agreement, the Employment Term may be terminated by either Company or Employee, at will, at any time and for any reason (with or without good cause) or for no reason, upon the expiration of sixty (60) days after written notice is mailed (by ordinary United States mail) or personally delivered by the terminating Party to the other Party. Company shall have the sole discretion to determine whether Employee shall continue to render services hereunder during such notice period but, for any termination under this Section 9.1, Company shall continue to pay Employee's Basic Salary in Section 3(a) during such notice period.

9.2 Employee's Death or Disability. In addition to termination under any other provision of this Agreement, the Employment Term shall terminate: (i) automatically, immediately and without prior notice upon Employee's death; or (ii) at Company's option, upon Employee's incurring a disability (as defined herein). For purposes of this Agreement, the term "disability" means any physical or mental condition resulting from accident or illness which prevents (as determined by Company in its sole discretion) Employee from performing Employee's then-existing duties and obligations under this Agreement.

9.3 Breach or Violation by Employee. In addition to termination under any other provision herein, Company may (at its option) immediately terminate the Employment Term, at any time and without prior demand or notice, if: (a) Employee breaches this Agreement or fails to perform (for any reason) any of Employee's obligations, duties, promises or representations under this Agreement, including (but not limited to) Employee's promises in Section 5; or (b) Employee commits a crime against Company or any of the Officers, Directors, employees, Patients or agents of Company; or (c) Employee commits any other crime (except a minor traffic violation) or any act involving fraud, dishonesty or moral turpitude; or (d) Employee fails to follow or adhere to any employment directive, order or employment policy issued by Company or by its authorized agent. xx[Optional: Consider adding cure period.]xx
9.4 Breach or Violation by Company. In addition to termination under any other provision herein, Employee may terminate the Employment Term, at any time and without prior notice or demand, upon Company's breach of this Agreement or violation of any of its obligations, duties, promises or representations under this Agreement.

9.5 Professional Status. In addition to termination under any other provision herein, Company may (at its option) immediately terminate the Employment Term at any time and without prior demand or notice if Employee is suspended from practicing dentistry [specialty] in the State of ________________.

9.6 Company's Discretionary Termination Option. In addition to termination under any other provision herein, for the first ninety (90) days of the Employment Term, Company may terminate the Employment Term at any time and without prior notice or demand for reasons good and sufficient to Company in its sole discretion.

9.7 Results of Termination of Employment Term. Upon termination or cessation of the Employment Term by either Party (for any reason, with or without cause), neither Party shall have any further obligation to the other Party, except for obligations which have accrued prior to such termination or cessation (including, but not limited to, Employee's promises and obligations under Section 5. Notwithstanding the forgoing, Company shall have no obligation to pay Employee any accrued Basic Salary ninety (90) days following termination of the Employment Term. During such ninety (90)-day period, Company shall provide Employee with an accounting of Employee's Basic Salary/collections during each of Company's usual and customary payroll periods.

10. Miscellaneous.

10.1 Headings and Captions. The headings and captions designated in this Agreement are for convenience only and shall not be used to interpret, enlarge or limit any provision of this Agreement.

10.2 Word Usage. For purposes of this Agreement, the singular includes the plural and vice-versa and the feminine, masculine and neuter include each other.

10.3 xx[State]xx Law. This Agreement is signed and executed in the City of ________________, County of ________________, ___ County, ___'s laws shall govern all disputes, controversies, matters of interpretation, and litigation arising hereunder. Company and Employee agree that, even if Employee is or becomes a resident of another State, exclusive venue for all litigation arising under this Agreement lies with the State Courts located within ________________ County, ______________ and, further, agree to submit (jointly and individually) to the personal jurisdiction of such State Courts.
IN WITNESS WHEREOF, the Parties have set their hands, as of the day and year first above written.

In the Presence Of:  

(Signature of First Witness)  

(Signature of Second Witness)

By: INSTRUCTIONAL USE — DO NOT SIGN  

xx[__________, DDS/DMD]xx, President -Company-

(Signature of First Witness)  

(Signature of Second Witness)

INSTRUCTIONAL USE — DO NOT SIGN  

xx[______________, DDS/DMD]xx,  

-Employee-
Figure 9-9

**SCHEDULE A**

Map

[To Be Attached Prior to Signing]
## Figure 9-10

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Chapter 10

USING RESTRICTIVE COVENANTS FOR
THE ASSOCIATE AND DEPARTING OWNER

The primary value of any practice is its patient and/or referral base. In order to protect
the patient and/or referral base, restrictive covenants are used as a tool to ensure that the parties
to an associate employment relationship, sale and acquisition, associate buy-in or owner buy-out
live up to their promises.

Enforcement

Enforcement of restrictive covenants vary from state to state. Irrespective of
enforcement, restrictions between owners where consideration is paid for a practice or practice
interest is more likely to be upheld than is a restriction relative to an employment relationship. The rational is that restrictions for employment of a doctor are inconsistent with public policy in allowing the public to receive professional treatment. This, however, depends upon the particular state's statute and/or case law, the reasonableness of restriction(s), the facts of the case and the damage, if any, sustained by the practice.

Associate employment, sale and purchase, associate buy-in and owner buy-out restrictive
covenant provisions share common prohibitions as to: (a) time; (b) geographical radius; (c) non-
disclosure of confidential information, e.g., patient lists and/or referral sources; (d) non-
solicitation — of patients, referral sources or employees of the practice. Such restrictions may
be in effect both during any employment term of the doctor and for some period of time thereafter.

Any agreement containing a restrictive covenant should include the transfer of the
restrictions to successors and assigns.¹ This is particularly important if you sell your practice
with an associate working in it to a third party. Without the language that the agreement
provisions go to successors and assigns, the associate may not have a valid restrictive covenant
with the purchasing dentist. If you purchase a practice with an associate(s) working in it, have
your attorney check to ensure that the restriction is applicable to your practice. Other/wise you
can have an associate competing with you who already had patient and/or referral contact,
maybe for a long period of time.

Associate Employment Relationships

These restrictions are the toughest to enforce as the associate has no equity in the practice
and the relationship between the practice owner and associate is one of employer/employee. If

the associate doctor is classified as an independent contractor, it may be arguably more difficult to enforce a restrictive covenant than if the doctor/worker is classified as an employee.

It's advisable to have the associate employment agreement signed which contains restrictive covenants prior to the employment commencing. The reason for this is that all contracts have consideration on both sides. In exchange for the associate's compensation, the associate promises to perform professional services and not to compete with the practice, solicit patients, referral sources or employees and not to retain or disclose confidential information. In the event that the employment begins working and the associate is receiving compensation in exchange for services rendered, there is arguably no consideration for the associate's later promise not to compete after the employment term commences. If the associate started working without signing the employment agreement with the restrictive covenants, a way to resolve the problem is to provide a meaningful signing or annual non-competition bonus. This may provide consideration for the associate doctor's later promise to sign the restrictive covenant provisions.

In the event that the associate may work at a second practice during the term of employment or if the employment is less than full-time, any ability to render professional services at another practice in or outside of the restricted areas should be specified in the employment agreement. The agreement may merely specify that the employer may, should the practice choose, grant or consent to such other employment in writing. In a full-time position, all revenues generated by the associate may be considered property of the practice if specified in the employment agreement.

One of the most difficult, but interesting restrictive covenant problems, is where the practice desires to protect itself from competition and dilution of value in the event the associate relationship does not workout, yet the associate grew up or resides in the same community where the practice is located. Protecting the practice, versus the ability of the associate to remain employed in the employee's hometown or place of residence, are competing goals. Usually, balance can be found with compromise, effort and all parties being reasonable. One way to effectively resolve this problem is to utilize a liquidated damage provision, whereby if the associate leaves the practice and works or sets up a practice within the restricted area, the associate would purchase his or her goodwill based on annualized production, e.g., 37% of one year's production. The liquidated damages provision would usually be a higher amount the longer the associate remains in the practice due to the associate's ability to attract patients and/or referral sources. This is one of the few instances where I recommend a liquidated damage provision and it would equal the goodwill produced by the associate.

Because courts typically look at the reasonableness of the restrictions to protect the legitimate interests of a business/practice, the court may consider the restrictions as overly broad. Certain states allow "blue penciling", whereby the agreement containing the restrictions may contain language which allows the court to reform the restrictions to what it considers reasonable rather than to not enforce the restrictions as all or nothing. Courts usually enforce contracts only within "the four corners of the contract" and do not permit the parties to the contract to present outside or parole evidence, except in certain instances. This is especially true if the contract contains an "integration" provision which states that the entire agreement is contained within the
written contract. Therefore, if the state allows blue pencilling, the employment agreement should provide specific language granting the court the power to reform the contract if the court determines the restrictions as overly broad.

Sometimes associate employment agreements contain "liquidated damages" as a deterrent to competition by the associate if the working relationship is unsuccessful. While a liquidated damage provision can relate to the value of the practice goodwill attributable to the associate, the court may not grant actual damages or an "injunction", which would prohibit the associate from competing if the liquidated damage provision is present. Too often, employment agreements contain extraordinarily high liquidated damage provisions, which are used as deterrents. These amounts have no bearing to the reality of the working relationship with the associate. It's questionable whether an extremely high liquidated damage amount would even be upheld. However, I would not recommend paying an attorney to find out.

The bottom line is don't sign what you don't agree to. I routinely get calls from unhappy associate doctors who question where the restrictive covenant provisions which they never meant to agree to, but signed, would be upheld. Since the agreement is already signed, the associate must live with what was agreed to.

The associate agreement should provide that the associate is not bound by any other employment agreement, particularly one which prohibits non-competition. If you are the hiring doctor, particularly if you have actual knowledge of a prior agreement, which restricts the associate from working in your practice, you and/or your practice could be liable to the other practice for intentional interference with contract.

Finally, the associate should not be overly intimidated by agreeing to reasonable restrictions to adequately protect the employer/practice. Without agreeing to such a protection for the practice, the associate probably won't get the job and the practice owner will be reluctant to introduce patients and/or referral sources. Further, assuming that the associate relationship is successful, the practice owner will later to be subject to similar restrictions in the event that the practice is acquired or the doctors become co-owners.

Sale and Acquisition

Another component of any practice sale and acquisition is the agreement by the selling doctor not to compete, in any entity, with the purchaser's newly acquired practice.

The time and geographic boundaries are typically more stringent than in associate employment agreements due to the purchaser's payment of consideration, the purchase price, for the practice; e.g., time - five years versus two years, geographical radius 15-20 miles versus 2-10 miles. With repayment periods increasing due to the success dental and other lenders have had with dentists and dental specialists, we are seeing 10 year repayment periods. Would you not want the seller bound by a restrictive covenant for 10 years? Unfortunately, I doubt that many states' laws would uphold such a lengthy restriction. This is a question that is important for your advisors to look into when purchasing a practice.
The restrictive covenant should be drafted to restrict the selling doctor during the period of time such selling doctor renders professional services on behalf of the purchaser's practice. It should also run for the time period agreed to beginning on the date when the selling doctor ceases to render services on behalf of the purchaser's practice. For example, one doctor worked for the purchasing doctor's practice just over five years. The purchaser fired the selling doctor thinking that the restrictive covenant was in effect. In reality, the five year period commenced on the closing date for the sale and acquisition, not on the date when the seller's employment was terminated by the purchasing doctor's practice. The selling doctor who remained in good health, bought a small practice a short distance from the purchaser's practice, hired former staff members and ended up treating all former patients whom he desired to treat. This situation was not intended by the purchasing doctor who had just relocated the acquired practice to an expensive new facility. The covenant period should have commenced when the selling doctor ceased to render services on behalf of the purchasing doctor's practice.

Many selling doctors do not want to sell their practices without the ability to continue to work on a limited schedule. While this factor may impact the determination of the purchase price and when it is paid, a phased in retirement can greatly assist the purchasing doctor to retain patients and seems to be a reasonable request. If, however, the selling doctor's employment is inappropriately terminated by the purchasing doctor's practice, a provision may be contained in the selling doctor's employment or independent contractor agreement, as the case may be, may provide that upon inappropriate termination, the selling doctor's restrictive covenants would be null, void and without effect.

In the event that the seller finances all or a portion of the selling price, the sale and acquisition documents should contain a "reverse covenant" whereby upon an uncured default by the purchasing doctor in the payment of the purchase price, such purchaser would be excluded from practicing dentistry in competition with the acquired practice according to the terms and conditions on which the seller had agreed not to compete with the seller's former practice. In a purchase or default, the selling doctor's restrictive covenants would be null, void and without effect. Of course, the selling doctor would also need access to patient records, the right to enter the practice facility and the ability to take over the facility lease.

**Associate Buy-Ins and Owner Buy-Outs**

In co-ownership arrangements, all doctors in the practice are typically prohibiting from competing. The rational here is that a buy-sell agreement should be in place which would dispose of an owner's interest in the event of death, permanent disability, retirement or termination of employment for any reason. In death, the departing doctor cannot compete. In permanent disability, the disabled doctor could compete if the disability would no longer exist, e.g., hand problems. Retirement, as a defined term, often triggers a mandatory buy-out and the practice or purchasing doctor(s) would not desire for the retired doctor to compete. If a doctor elects to depart from practice and terminates employment, the other doctor(s) or practice may have the option to acquire the interest of the departing doctor. If the would not be exercised, the departing doctor would attempt to sell his or her interests to a third party candidate, with
authorization of the remaining doctor(s). In such case, neither the third party incoming doctor nor the other doctor(s) in the practice would desire for the departing doctor to compete.

Upon an owner's retirement, the retiring owner's interest would typically be purchased by the remaining doctor(s), through an obligation, as opposed to an option. In any buy-out, the remaining doctor(s) would not desire for the retiring owner(s) to compete. Notwithstanding the necessity of strongly written restrictive covenant provisions, the remaining doctor(s) should consider making the retiring or departing doctor(s) payments for any practice interest contingent upon compliance with the non-competition provisions. Payments by the practice or remaining owner(s) to the retiring or departing doctor are usually paid over time. This is in contrast to cash in full at closing in a complete sale and acquisition of a solo practitioner.

Termination of employment for any reason, including dispute, may trigger a penalty buy-out provision, yet the restrictive covenants would remain in place for any buy-out of an owner.

Sometimes the doctor(s), owner(s) will agree not to practice together and will retain their respective patient and/or referral basis, split the tangible assets and retain their own practices. In such case, restrictive covenant provisions would not be in effect as no doctor is bought out.

There are several instances where restrictive covenant provisions can be used to protect the practice. While usually applicable to associates and owners, it is advisable to restrict staff members from disseminating confidential information. The patient base is both valuable and confidential and downloading confidential practice information is easier than ever today.
Chapter 11

PLANNING ASSOCIATE BUY-INS & OWNER BUY-OUTS

Can co-ownership work? Yes, assuming that defined parameters are met. Some are described in Figure 11-1. While co-ownership can be more rewarding than solo practice for purposes of coverage, efficiency and another doctor(s) to work with, it is clearly more complex. This is because we need to deal with three categories; the buy-in, the buy-out and operations. In addition to the three categories, there are three business and tax structures to choose and two have problems under certain circumstances. Yet, co-ownership is becoming more common than in the past 35 years as some practices grow, then expand or relocate.

Not surprisingly, co-ownership works best for large (at least $1.8 million in annual collections), family and specialty practices. These practices are sold in "pieces" by Dr. Junior(s) being elevated to ownership.

As a former dental equipment and supply salesman of 16½ years, I remember the dental groups of the mid-1970's that did not survive into the 1980's. The reasons that co-ownership failed then are the same as now. Some of these reasons are listed in Figure 11-2. If you can learn from the past in light of the criteria listed in Figure 11-1 above, the co-ownership should prove successful. Time will tell!

Review Your Succession Options Again!

Your exit and practice options are: (a) a complete sale; (b) hire the associate with a complete sale in one to three years; (c) enter into a solo group arrangement; (d) enter into co-ownership; or (e) work for an additional one or two years and close the practice. Prior to entering into co-ownership, you should examine all options with your spouse and advisors in light of what you want in life and how long and how many days/hours per week that you choose to work. A review of the succession and entry options is important because after this analysis, you may decide against co-ownership as the exit strategy choice for you.

If you are or will be in a co-ownership, Dr. Junior should agree to be obligated to buy you out upon the earlier of your death, permanent disability or election to retire on or after a specified date. Unfortunately, Dr. Junior has no need to buy you out once Dr. Junior has reached full capacity. If Dr. Junior will not be obligated to buy you out at retirement, your interest becomes almost worthless to find a Dr. Three to buy you out and become an owner with Dr. Junior. While you and Dr. Junior may agree upon Dr. Three, if Dr. Three does not work out, the obligation remains with Dr. Junior.

If you practice with another doctor roughly the same age, it is likely that you will agree that one of you is not required to buy-out the other of you, except for death or permanent disability. Understand well in advance that continuous increases in revenue will be required to ultimately hire, train and mentor two or more replacements who desire to practice with each
other. As an alternative, consider terminating the co-ownership and form a solo group. This can allow each group practice owner to hire an associate and sell your separate practice upon retirement. Thereafter, each new practice owner would be a party to the solo group arrangement. The key here is to maintain separate patients, which does not work well in specialty practices although it can, and recognize that one owner in a two practice facility will need a new telephone number. Generally, the solo group member who retains the existing telephone number pays for it.

With a minimum of seven years to plan for your exit, the difficulty of candidate selection and completion of the succession process should be less stressful than otherwise. What is an interesting and healthy trend is that professionals are not completely retiring, but continuing to work on a reduced schedule. Continued work should not present a problem, assuming that the practice valuation and timing of payments consider the reduced schedule. Nevertheless, your continued employment should be within the control of Dr. Junior(s) who must earn a reasonable living, pay the operating expenses and pay the lender(s), within a measured time period.

If you plan to work six years or less, do not enter into co-ownership because there isn't sufficient time to be paid for the first half of the practice before you leave. In this case, pay Dr. Junior well for three years, then sell Dr. Junior the assets of your practice and your personal goodwill in a complete sale. The purchase (except for related parties where the practice was formed before August 10, 1993) will be deductible to Dr. Junior and mostly capital gains to you. Then work for Dr. Junior who owns 100% of the practice for three years and by mutual agreement thereafter.

**Joining the Practice**

Unless the hiring of a permanent associate is contemplated, make sure that your written succession/exit plan is in place, the valuation is completed (in light of any required expansion or relocation) and the tax and business structure of the succession plan is specifically delineated prior to Dr. Junior commencing employment. Where this is done, co-ownership usually works well, assuming that the associate period is successful. If not, a failed associateship does not change your succession plan and a new candidate would be considered.

In the event that Dr. Junior desires to review any tax, financial or other confidential information for your practice, Dr. Junior should sign a written confidentiality letter.

After the succession plan is completed, the next step for you is to complete the interview process of qualified candidate(s). This may include the use of personality profiling and testing tools. The candidate's background and references should then be investigated under a written release. Upon accepting a written employment proposal, Dr. Junior signs a written employment agreement that delineates a restrictive covenant, compensation and discretionary bonuses, payment of direct business expenses, benefits and insurances, work schedule and on-call responsibilities, vacations and other time-off and termination of employment.
In addition to the associate employment agreement, have your attorney prepare a detailed letter of understanding that outlines the associate buy-in, allocation of compensation, decision making control, employment of family members and buy-out of an owner for any reason in light of the three business and tax structures. Then authorize your attorney to prepare all ownership agreements (including your post-retirement employment agreement) prior to the associate picking-up a handpiece.

Five additional comments on associate employment are worth noting. First, associate bonuses should not generally be productivity based; they should be discretionary in order to measure Dr. Junior's total contribution to the practice in light of its cash and financial position. Measuring only productivity completely misses quality of work, effort, working relationships with staff members, patient responsibility, efforts to further develop the practice, among other things. A discretionary bonus forces you to communicate with Dr. Junior and rate him or her on a multitude of factors, inclusive of productivity, and justify the outcome.

Second, given the profitability of your practice in light of the market for or availability of quality candidates, your practice must earn an administrative profit on the associate. An overpaid associate is a disaster to future ownership. If you do not earn an administrative profit of roughly 10% to 15% from Dr. Junior, there will be insufficient profitability to admit him or her as a future owner. Because Dr. Junior will not desire to take reduced compensation as an owner, the only available revenue to pay for the future ownership is hygiene profit in a general practice and the difference between owner compensation in all forms and associate compensation. This is why practice profitability is so important to future associate ownership.

Practice management consultants can be instrumental and extremely helpful in systems development, staff training, computer integration, goal setting, fee determination, coding, insurance documentation, revenue enhancement and many other factors. With the assistance of the management consultant, each owner should take the initiative to become a "leader" of and learn how to manage the practice. Like any other business expenditure, the engagement of the management consultant should provide the practice with a return on investment. An improved bottom line assists in allowing Dr. Junior to grow into ownership.

Dr. Junior does not begin work until the associate employment agreement is signed. Failure to sign the employment agreement can make any later agreed to non-competition/non-disclosure provisions null and void unless consideration, in the form of compensation or a bonus, is paid for the later promise not to compete.

Finally, always look for an additional practice to purchase near your location. This can assist in allowing Dr. Junior to increase collections sufficient to become an owner.

The valuation of the practice in a co-ownership or a group practice is identical to the valuation in a complete sale, except that Dr. Junior acquires a proportionate interest in your practice. For example, if Dr. Junior produces 50% of the doctor revenue, Dr. Junior would acquire a 50% interest in your practice. If Dr. Junior produces 25% or 33⅓% of the practice...
Joining And Leaving The Dental Practice
Planning Associate Buy-Ins & Owner Buy-Outs
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revenue, Dr. Junior would purchase a 25% or 33⅓% interest. The interest purchased by Dr. Junior should match his or her percentage of practice productivity. This allows Dr. Junior to both pay for the practice interest and not reduce compensation below the associate level, assuming that the practice properly valued and Dr. Junior is not overpaid. And yes, this allows Dr. Junior to be elevated to ownership without collecting 50% of the doctor revenue. As productivity increases, Dr. Junior's percentage of ownership also increases.

The Three Business and Tax Structures

There are three business and tax structures for associate buy-ins and owner buy-outs; the purchase and sale of stock in after-tax dollars, stock excluding goodwill coupled with a compensation shift for the buy-in and deferred compensation or payment of personal goodwill for the buy-out and the three entity method. Two of these business and tax structures present tax risks. As a result, if you are planning to admit Dr. Junior to your practice or are in co-ownership, you need to be aware of significant tax risks that your other partner, the IRS, thinks is important under the business and tax structures. In addition, the three categories of co-ownership (the buy-in, the buy-out and operations) need to be considered when the relationship is contemplated. Dealing with these complex issues a year or two after the associateship begins are likely to lead to disagreements over the purchase price, valuation date, and the business and tax structure. The business and tax structures are the same, irrespective of whether there are two or more owners.

Purchase and Sale of Stock In After-Tax Dollars

The first business and tax structure is the purchase and sale of stock in a professional corporation in after-tax dollars. It is the only one without any tax risk. Unfortunately, it is also the one used the least.

Under this structure, Dr. Junior pays income tax on all compensation earned and then pays for the stock in after-tax or non-deductible dollars, while you pay tax as capital gains on the proceeds from the sale of the stock. Therefore, all taxes are accounted for and you, Dr. Junior and the practice are free from IRS scrutiny in the event of an audit.

This business and tax structure only works from an economic standpoint where the tax-neutral fair market value of the practice is adjusted downward to account for Dr. Junior paying for stock without any ability to deduct the purchase price in light of your receiving capital gains treatment. The downward adjustment applies to both the buy-in and buy-out. However, when Dr. Junior sells his or her stock in the future, Dr. Junior only pays capital gains above the purchase price paid for both the buy-in and the buy-out.

Stock Excluding Goodwill

Risk 1 – Compensation Shifts

The purchase and sale of stock for the buy-in to a professional corporation excluding goodwill, usually the fair market value of the professional corporation's tangible assets, is
sometimes coupled with a compensation shift to you, which represents your goodwill. In exchange for selling a fractional interest of your goodwill, you receive additional compensation, often increased for the tax effect of receiving ordinary income instead of capital gains and again for an interest component, by providing administrative and management services to the practice under a practice management agreement. The tax effect of a compensation shift is included as Figure 11-3 and an employment agreement provision is included as Figure 11-4.

Compensation shifts have not yet presented tax problems in the buy-in piece of the transaction, assuming that the compensation shifted equates to the management services provided. However, this could change given that the IRS can make an argument that the compensation shifted is a non-deductible dividend if your practice operates as a C-corporation.

### Risk 2 – Personal Goodwill for the Buy-In

Rather than utilize compensation shift, some advisors are advocating Dr. Junior's purchase of personal goodwill for the buy-in. However, personal goodwill is not deductible to an individual who is not a "trade or business".

### Risk 3 – Deferred Compensation

Sometimes buy-outs are structured with stock being purchased by the professional corporation, excluding goodwill, coupled with the payment, over time by the practice to you of deferred or continued compensation, which represents your remaining goodwill. While payments for deferred compensation are deductible to the practice, they are taxable as ordinary income to you. Moreover, deferred compensation arrangements are now subject to the complexities of IRC Section 409A and its harsh penalties for non-compliance. The primary effects to you are strict rules on the payment of accounts receivable and no ability to prepay the deferred compensation.

### Risk 4 – Personal Goodwill for the Buy-Out

Another buy-out structure, which is supported by case law, is where your stock is purchased by the practice excluding goodwill, but is coupled with the purchase by the practice of

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4. IRC Reg. 1.212-1; Harry R. Haury v. Commissioner, T.C. Memo 2012-215; Code Sec(s) 72; 408; 166; 6651; 6654; 7491.


6. The following Technical Advice Memorandum and Revenue Ruling recognize the partial transfer of personal goodwill: TAM 200244009; Revenue Rule 70-45.
your personal goodwill. To the extent that there is personal goodwill, the purchaser, which is the practice and not Dr. Junior, is able to amortize or deduct the personal goodwill over 15 years while the purchase of stock cannot be deducted. To you, the personal goodwill should, arguably, be taxed at capital gains at one level and not double taxed.

Understand, however, that the purchase and sale of personal goodwill is not without problems. First, if personal goodwill is part of the transaction, you cannot be, or have a written agreement that you will be, subject to a restrictive covenant with the practice upon the buy-out. This point effectively eliminates this business and tax structure because Dr. Junior will require that you be subject to a restrictive covenant and vice-versa. Second, if the practice was formed prior to August 10, 1993, the goodwill is not deductible. If this method is used, it is important to have an appraisal that distinguishes your personal goodwill versus any corporate goodwill.

Three Entity Method

Finally, an increasingly common business and tax structure for co-ownership is for Dr. Junior to form an S-corporation and purchase a fractional interest in the tangible assets and goodwill from you or your practice entity. After the purchase, you and Dr. Junior operate the practice through a newly-formed limited liability company or partnership, a third entity, that collects the revenue, pays the operating expenses including employee benefits and employs the staff. Profits are distributed to the entities, which are owned by you and Dr. Junior and which pay the direct business expenses of each owner. The three entity method may also include use of a compensation shift, the purchase of personal goodwill, questionable S-corporation distributions (because all distributions from limited liability companies and partnerships are earned income) and/or independent contractor relationships. Note that the tangible assets are owned by the respective corporations because the transfer of equipment to the limited liability company or partnership will create a taxable event. New purchases of equipment and technology, however, can be made by the third entity, the limited liability company or partnership.

Risk 5 – The Anti-Churning Rules

If your practice was formed prior to August 10, 1993, the buy-in and buy-out under the three entity method, as well as the purchase of personal goodwill by the practice upon your buy-out, is subject to the IRC Section 197 anti-churning rules. The anti-churning rules deny amortization of the goodwill purchased by Dr. Junior if you and Dr. Junior jointly did or will

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7 The following recent cases recognize the existence of personal goodwill: *Muskat v. U.S.*; 554 F.3d 183; *Solomon v. Commissioner*, T.C. Memo. 2008-102, 208 WL 1744406 (U.S. Tax Ct.).


9 The Tax Advisor, September 2009, 9-09 T.T.A. 573, Thomas I. Broder, Elkart, IN.

10 IRC Section 197(f)(9)(A)(i); IRC Reg. 1.197-2(h)(2)(i).
own twenty percent or more of the third entity\textsuperscript{11} or are family members, e.g., you and your son or daughter/dentist. It is the third entity, the limited liability company or partnership, that creates the problem for non-related owners because 20% or more common ownership makes you related parties. IRC Section 197 does not provide for separation of the pre and post-August 10, 1993 goodwill.\textsuperscript{12} While I have not seen any audits on this point yet, note that the IRS is well aware of this situation and has stated that it can track asset sales through Forms 8594 that must be filed by both you, your corporation, and Dr. Junior.\textsuperscript{13} There is direct authority under the IRC Section 197 Regulations for the IRS to recast the transaction to avoid the requirement that the intangible be acquired after August 10, 1993 or to avoid any of the anti-churning rules.\textsuperscript{14} While the IRC Section 197 Regulations provide guidance to avoid the anti-churning rules in Example 19\textsuperscript{15}. Here, Dr. Senior's S-corporation contributes its tangible assets and Dr. Senior contributes his or her personal goodwill to a newly formed limited liability company in year one. On the first tax return, the limited liability company makes what is called an IRC Section 754 Election. In year two, Dr. Junior purchases 50% of Dr. Senior's membership interest in the limited liability company. However, Example 19 seems to conflict with the authority of the IRS to recast the transaction. As a result, I am not convinced that following Example 19 is a solution. In addition, we cannot locate dental appraisers to appraise personal versus corporate goodwill, as opposed to the goodwill of the entire practice. If Example 19 is utilized, an appraisal of the personal goodwill is important.

If, on the other hand, you and Dr. Junior operate separate practices under a solo group arrangement with no common ownership of a third entity, the goodwill is amortizable for the buy-in and buy-out, except for family members. What's more, each separate practice may adopt its own tax-qualified retirement and health plans without covering the eligible employees of both practices. Shared employees, e.g., hygienists, are permitted under solo group arrangements. Notwithstanding the ability to amortize pre-August 10, 1993 goodwill, solo groups work well because Dr. Junior is usually not required to purchase your practice upon retirement but retains the option to do so. Because the practices are separate, you can sell your practice to a third party dentist if Dr. Junior does not exercise the option to purchase. Death or permanent disability, however, usually requires a mandatory purchase. Compensation allocations in a solo group tend to benefit you more than in co-ownership arrangements because each practice owner usually pays 50% of common operating expenses.

\textsuperscript{11} IRC Reg. 1.197-2(h)(6)(i)(A).

\textsuperscript{12} Mergers, Acquisitions, and Buyouts, Martin D. Ginsburg, Jack S. Levin, Aspen Publications, 4-118, Example 17, Section 403.4.4; December, 2002; Example 20, Section 403.4.1.4, February, 2012.

\textsuperscript{13} American Bar Association, Section of Taxation, Meeting, Toronto, September 24, 2010, "Co-ownership – Taxing Decisions".

\textsuperscript{14} IRC Reg. 1.197-2(j).

\textsuperscript{15} IRC Reg. 1.197-2(k), Example 19.
Business and Tax Structure Summary

Remaining a solo practitioner is best, and practicing in a solo group, second best. If you are contemplating admitting Dr. Junior as a co-owner or are in co-ownership, any of the three business and tax structures can work if the tax risks are recognized and not taken. Hire advisors with experience in these transactions and expect tax risks to be disclosed.

Stock in After-Tax Dollars

If the practice was formed prior to August 10, 1993, my recommendation for co-ownership is the purchase and sale of stock and after-tax dollars, with adjustments for the tax benefit in light of the tax detriment. It is simple. There are no tax risks, and there is one entity.

Stock Excluding Goodwill

While a headache to calculate and keep track of, stock excluding goodwill, coupled with a compensation shift is workable for the buy-in piece. Stock excluding goodwill, coupled with Dr. Junior's personal purchase of your personal goodwill is not deductible to Dr. Junior because Dr. Junior is not a trade or business. For the buy-out, stock excluding goodwill coupled with deferred compensation, works well provided that you understand that the payments will be over time. Stock excluding goodwill, coupled with the professional corporation's purchase of your personal goodwill is viable provided that you do not, or have not agreed in writing to, have a restrictive covenant with the practice and provided that the practice was formed after August 10, 1993. Very unlikely!

Three Entity Method

The three entity method does work well if the practice was formed after August 10, 1993, and the owners are unrelated. This notwithstanding the complexity and increased accounting costs of operating three entities. If the practice was formed prior to August 10, 1993, understand that the goodwill sold is not amortizable or deductible to Dr. Junior for either Dr. Junior's buy-in or your buy-out. Stay away from S-corporation dividends with the three entity method and do not attempt to classify the member/partner-corporations as independent contractors. Finally, solo group arrangements provide a good alternative for general practices to allow for goodwill to be amortized where it would otherwise not be.

Ask that your advisors keep your other partner, the IRS, in mind when developing the business and tax structure of your co-ownership for both the buy-in and buy-out with Dr. Junior.

A list of the advantages and disadvantages of each buy-in and buy-out method is included as Figures 11-5 and 11-6.
Operational Considerations

Retirement Plan Funding

Some consulting companies promote that Dr. Senior should design his or her practice's retirement plan to the anticipated profit from the production of Dr. Junior as a defined benefit or cash balance plan. The problem is that these contributions are mandatory and can be a problem to make if Dr. Junior leaves the practice. Here, Dr. Junior receives less compensation than Dr. Senior for several years, with the excess compensation being contributed to the practice entity's retirement plan. Depending upon the age and income of the doctor/owners and staff, the benefit can be very significant to you as Dr. Senior. However, this mechanism is one "tool" in a "toolbox" and is not applicable to all practice owners. Some of the points to consider before doing this are listed in Figure 11-7. Retirement plans can be designed as safe harbor 401(k) profit-sharing plans and may be "cross-tested" to consider age to provide additional benefits to the practice owner(s) with a minimum mandatory contribution. If the practice must expand or relocate as a result of Dr. Junior joining, there may be an impact upon the ability of the practice to make substantial retirement plan contributions.

Allocation of Compensation

Compensation, bonuses, direct business expenses, benefits and insurances are usually allocated in one of five ways or through a combination as follows: (a) by the respective collections or productivity of one owner as a percentage of the collections or productivity of all owners, and whereby general operating expenses may (or may not) be equally shared; (b) by pro rata ownership percentage; (c) by administrative and management responsibilities; and/or (d) by the number of days, half-days or time spent working in the practice. Note that retirement plan contributions are based on total compensation by law and it is sometimes challenging for multiple owners to agree on the same plan design and funding level. This matter can be handled through the compensation formula.

It is still common to allocate yearly or quarterly compensation as follows; the sum of the available compensation multiplied by a percentage, the numerator of which is the percentage of the respective owner's collections as a percentage of all owner's collections, and the denominator of which is the collections of all owners. Here, expenses are not equally allocated but paid by the practice. Monthly draws (usually paid every two weeks), direct business expenses, individual insurances and individual benefit costs would are subtracted from the yearly or quarterly profit distribution. Granted, I recognize that S-corporation distributions can escape the Medicare tax above the Social Security wage base or retirement plan contribution amount are on the basis of ownership percentage. This allocation is favorable to Dr. Junior who generally collects less than Dr. Senior. Note that in compensation allocations, hygiene and associate profit are included in the distributable profit to owners.

An allocation that may be more appropriate is to allocate expenses equally on a pro rata basis of ownership, then distribute profits as indicated above as a percentage of the collections of the respective owner to the collections of all owners. An example of such a compensation
formula is in Figure 11-8. Also, see Figures 11-9 through 11-14. In these examples, compensation is allocated in a two owner practice on the basis of $1 and a practice collecting $2 million annually. In the first set of examples Dr. Senior collects 60% of Practice Revenue and Dr. Junior 40%. In the second example, Dr. Senior collects 55% and Dr. Junior 45%. In the third example, Dr. Senior and Dr. Junior collect equally. These examples show that allocating operating expenses on a pro rata basis will penalize Dr. Junior to the extent that his or her collections are lower than Dr. Senior's. However, Dr. Senior is penalized to the extent that his or her collections are greater than Dr. Junior's if operating expenses are not equally shared.

Don't know about you, but I expect my partners to pay their equal share of our operating expenses. I believe that it is unfair for the "producers" in any practice to pay more than their equal share of common operating expenses. These allocations continue to be a problem where associates are admitting to ownership too early. And when evaluating whether the appraised fractional interest is "fair" to Dr. Junior and Dr. Senior, it is essential for the compensation formula to be delineated.

The owner employment agreements allocate owner compensation in all forms. Such agreements usually contain the similar provisions provided for in an associate employment agreement with the following exceptions: (a) the compensation is more generous for owners than associates; (b) the restrictive covenants are generally for a longer period of time for owners than for associates; (c) direct business expenses, benefits and insurances, as well as time-off policies are generally more liberal for owners than associates; and (d) it is usually, but not always, more difficult to terminate the employment of an owner versus an associate.

**Decision Making Control**

Decision making control can be equally allocated among the owners or vested in one or more owner(s) under the particular state's close corporation or shareholder agreement statutes. Not every state has such a statute in effect. For those approximately sixteen states that do, the "founder" or owner can avoid the necessity of retaining a 51% ownership interest in the practice for maintaining control or the use of a separate class of stock for voting and non-voting interests. If the practice operates in a corporate format under such a statute, operational control or the "tie-breaking" vote can be vested in the founder(s) or you so long as you own at least one share of the professional corporation's stock. Voting control can also be allocated to the other owners in order of seniority or by some agreed upon method. For those practices operating as a limited liability company, management control can usually be allocated through the operating agreement, depending upon the state.

The incoming owner(s), however, would desire to share equally in decision making or operational control of the practice. If not, the incoming owner(s) should propose to reduce the practice value to reflect a "lack of control" discount. From Dr. Junior's perspective, any interest in the practice should be equal to yours, e.g., 50% in a two doctor practice. Otherwise, the relationship is not a true partnership and perhaps should not be entered into.
Almost all associate buy-ins are internally financed, as any lender would require the practice or your guaranty as security. This would mean that you would have to guarantee the loan for the buy-in. While this is sometimes done, it is much more likely that the associate buy-in will be internally financed. Assuming that the associate buy-in is internally financed or the loan guaranteed by you, then you may retain decision making control in the practice until the buy-in is fully paid. However, certain decisions should require the unanimous consent of all owners, e.g., the hiring of an additional dentist or specialist, expenditures over a threshold amount, relocation of the practice and/or the acquisition of an additional practice. Thereafter, decision making control is equal, assuming that dispute resolution controls are built into the shareholder or operating agreements. An example of such a control mechanism would be a determination of who would remain in the practice location and who would relocate in the event of a dispute. Sometimes a provision is included in the new owner's employment agreement whereby you can terminate Dr. Junior's employment by notice, but are penalized by 50% of the value for doing so. If this provision is triggered, Dr. Junior may be permitted to practice within the restrictive covenant area so long as Dr. Junior's interest is fully paid for. If Dr. Junior quits prior to completing the buy-in and your buy-out, Dr. Junior is similarly penalized; typically 50% of the value.

Dispute Resolution

Dispute resolution devices should always be in place in co-ownership and serve to resolve voting deadlock. The buy-sell agreement, close corporation or other shareholder or operating agreement for a limited liability company would typically contain one or multiple dispute resolution devices which would affect an owner's buy-out or departure from the practice. This may include an agreed upon arbitrator, a "Russian roulette" provision whereby one owner must buy out the other owner should one make an offer and the other not accept, or a corporate division under IRC Section 355 which would divide the professional corporation into separate practices tax-free if certain technical requirements are met.

For co-ownership to be successful, the shareholders, members or partners should commit to holding regularly scheduled board, member or partner meetings with a written agenda to discuss practice business. Further, a yearly meeting should be held with a CPA and attorney for the practice and any other key advisors to review practice operations for the most recent fiscal or calendar year and plan for the next and future fiscal or calendar year in accordance with a written strategic plan.

Employment of Family Members

While you are the only owner, the employment of family member(s), e.g., your spouse works well. However, in co-ownership, employment of family member(s) should always be discussed and agreed upon in advance. Where your spouse is employed by your practice, such employment will be a condition of Dr. Junior being elevated to ownership.

With regard to the buy-in of family member(s) as dentists or specialists, I have one simple rule. Handle the buy-in and later buy-out as if the family member(s) is unrelated to you.

Entity Selection

For those of you who practice as sole proprietorships, consider forming an S-corporation or limited liability company prior to admitting Dr. Junior as a shareholder or member. Do not form a C-corporation due to the potential double tax on the sale of practice assets. While there used to be favorable fringe and retirement benefits by practicing in a C-corporation, all entities are now almost equal. Allowing Dr. Junior to become an owner as a sole proprietor makes your practice a partnership by default. Partners are jointly and severally liable for the acts of each other and that is undesirable in the event of litigation against one partner by a plaintiff.

If you operate as a S-corporation, which can still have "reasonable" distributions that avoid the Medicare tax above the retirement contribution or Social Security Wage Base (unlike any other entity), or operate as a C-corporation, corporate formalities are necessary to maintain liability protection. An example of annual Shareholder and Directors' Minutes are included as Figure 11-15. An example of a Year-End Information Sheet developed by a Firm over the last 35 years, is included as Figure 11-16. From the completed Year-End Information Sheet, your counsel can prepare Minutes for your corporation once per year and these Minutes will be included in your corporation's record book.

Some advisors advocate the three entity method on the belief that Dr. Junior's ownership in Dr. Senior's S- or C-corporation has potential liability. I have never experienced this in 23 years of practice and note that ownership of a third entity is also common ownership. Of course, you should indemnify and hold harmless Dr. Junior from any liability created prior to Dr. Junior becoming a shareholder and the share purchase agreement would provide for this.

Buy-Sell Agreements

The most overlooked aspect of co-ownership is the buy-sell agreement. While associate buy-ins are usually internally financed, unless you or your practice guarantee Dr. Junior's loan and I would not, an owner's buy-out should be payable in cash because the remaining owner(s) can provide the practice as security for the loan. An exception is where Dr. Three buys you out. Here, Dr. Junior or Dr. Two would not want to participate in Dr. Three's buy-out of you and would not want to guarantee the loan either personally or through the practice entity.

The buy-sell agreement under any method should provide for the remaining owner's or practice's mandatory or optional purchase of an owner's interest in the practice entity if a specified triggering event occurs. The decision between a mandatory or optional purchase and sale is often determined by the type of triggering event. An involuntary triggering event such as death, permanent disability or attaining a predetermined retirement age, whereby you elect to retire, typically would require a mandatory buy-out. Any other termination of employment with the practice, voting deadlock or dispute may provide for a reduced purchase price and may be made over time, unless you terminate the employment of Dr. Junior without cause. The buy-sell agreement may also provide for an optional buy-out, usually where the owners are near the same age. Attached as Figure 11-17 is a matrix which describes those triggering events generally
included in buy-sell agreements; mandatory or optional buy-outs, payment terms and use of insurance for death or permanent disability.

The buy-sell agreement(s) would be drafted to reflect the purchase and sale based upon the business and tax structure of the buy-out. Except for the payment of deferred compensation and possibly internal financing between family members, the buy-out should be in cash. The remaining owner(s) would use the practice as security to pay the purchase price. In the rare event that outside financing would not be available, the buy-sell agreement would provide, for example, that the purchaser, the practice or the remaining owner(s) would pay a percentage, e.g., 3%, above the prime rate charged by the practice entity's bank on the purchase date.

One termination of employment/dispute resolution decision that usually, but not always, utilizes stock in after-tax dollars approach, may be as follows. You may retain the ability to terminate the employment of Dr. Junior and Dr. Junior retains the ability to quit.

If you terminate Dr. Junior's employment by notice, the purchase price contained in the buy-sell agreement is increased by 50%, less the unpaid portion of the purchase price for the buy-in and (in a two owner practice) is paid to Dr. Junior by you in cash. However, Dr. Junior may elect to practice within the area covered by the restrictive covenant. If so, Dr. Junior may retain the charts and records of those patients customarily treated by Dr. Junior and may be permitted to practice within the restricted area. This assumes that Dr. Junior has paid for Dr. Junior's 50% interest in your practice. The purchase price would equal the pro rata interest in the tangible assets, less the tangible assets that Dr. Junior would take. An example of tangible asset value is included as Figure 11-18.

If Dr. Junior quits without purchasing the second half of your practice upon the earlier of your death, permanent disability or retirement, the purchase price under the buy-sell agreement to Dr. Junior is decreased by 50%, less any unpaid balance for the buy-in through the internal financing.

If Dr. Junior desires to practice within the area covered by the restrictive covenant, Dr. Junior retains the chart and records of those patients customarily treated by Dr. Junior and may be permitted to practice in the restricted area. This assume that Dr. Junior has paid for Dr. Junior's 50% interest in your practice. The purchase price would equal the pro rata interest in the tangible assets, less those tangible assets that Dr. Junior would take. However, there may be a liquidated damage amount for Dr. Junior to relieve the obligation to buy you out.

The ability of Dr. Junior to fully pay for his or her interest in the practice and work within the restricted area can be a useful tool for a third party owner who is an owner with two or more family members, e.g., husband and wife dentists. Note that any ability of Dr. Junior to practice or not to practice in the area covered by the restrictive covenant would be clearly set forth in the buy-sell agreement(s).
The purchase price for a buy-out should be determined in one of three ways. Either by: (a) agreed value; (b) formula; or (c) appraisal.

**Agreed Value**

While agreed value is definite, it does not account for future growth of the practice. This is often used where the stock of a professional corporation is appraised at tangible asset value, excluding goodwill, or if Dr. Senior is retiring at a pre-determined date in the not too distant future, e.g., within two years. Sometimes this formula is coupled with a pro rata percentage of the cost of additional tangible assets and technology (as mutually agreed by the owners) from the date that the buy-sell agreement is signed until the retirement or other departure date. An example of an agreed value is described in Figure 11-19.

**Formula**

The formula approach is common because it provides for a pro rata increase for practice growth. If a two owner practice significantly increases in value, the formula provides for the departing or retiring owner to share one-half of the increased growth in a two owner practice. There are several formula variations and an example is included as Figure 11-20. The challenge with formula determinations of purchase price is to make it easily quantifiable and understandable.

**Appraisal**

In the past, I did not care much for the appraised method of determining the purchase price. The reason for this was because the appraisal results vary greatly among appraisers of dental and dental specialty practices, the time it takes to prepare the appraisal and cost. I have since changed my view for a few reasons. First, if the appraiser is designated by name or if the specific appraiser is unavailable, an appraiser is agreed upon by the owners. Additional language can be added about two appraisers selecting a third and economic or percentage limits of the appraisal can be added. Second, the buy-sell agreement would contain a provision that the most recent appraisal will control the purchase price until updated. Third, once an appraisal is prepared, it can be quickly and inexpensively be updated. Finally, the owners can agree to have an updated appraisal completed every year as contained in a schedule to the buy-sell agreement. An example of appraisal language contained in a limited liability company operating agreement is included as Figure 11-21.

**Can Co-Ownership Work?**

Yes, provided that you and Dr. Junior are compatible, the practice is economically healthy, your facility has expanded or relocated, compensation in all forms and operating expenses are allocated fairly, the economic terms of the associate buy-in(s) and owner buy-out(s) are fair to all parties, decision making control is agreed upon, spousal involvement is agreed upon and Dr. Junior agrees to buy you out upon retirement or in the event of a catastrophe, then
co-ownership works very well. The difficulty is complexity, which is why practicing solo or in a solo group arrangement is, in my view, a better alternative than is co-ownership.
Figure 11-1

CRITERIA FOR SUCCESSFUL CO-OWNERSHIP

1. Dr. Junior agrees to a mandatory buy-out of Dr. Senior upon retirement in accordance with a predetermined and agreed upon formula to account for future practice growth; incentives and disincentives in place to ensure that the parties live up to their obligations;

2. Practice valuation and transition memorandum are prepared as early as possible;

3. There is a "way out" or exit that is available for any owner;

4. Patient base remains separate for each owner and any associate dentist in general practices;

5. The practice is economically healthy;

6. There are sufficient new patients and growth;

7. The existing owner(s) cannot incur a drop in compensation, unless time in practice is reduced;

8. The owners are compatible with each other;

9. The economics of the associate buy-in are "fair" to both or all parties;

10. Compensation and benefits are allocated fairly;

11. Decision making control of the practice is agreed upon by both or all parties, with dispute resolution devices in place;

12. Spousal involvement in the practice is agreed upon by both or all parties in advance.
Figure 11-2

COMMON REASONS WHY CO-OWNERSHIP RELATIONSHIPS FAIL

1. The economics of the associate buy-in(s) and owner buy-out(s) are incorrect and unrealistic;
2. Insufficient patients and/or referral sources;
3. Disproportionate quality of clinical treatment;
4. Disproportionate productivity;
5. Disproportionate effort;
6. Varying long-range or strategic goals;
7. Failure to discuss practice business through regularly scheduled board or owner meetings;
8. Practicing in the wrong location;
9. Inefficient facility design;
10. Inability to compromise;
11. Personality conflicts and other personality issues;
12. Ineffective management and/or delegation of management duties and responsibilities, including staff training;
13. Ineffective leadership; and/or
14. Inadequate, unrealistic, outdated or the absence of buy-in, operational and buy-out documents.
**Assumptions**  
Capital Gains – 20%  
Ordinary Income – 40%  

### Per $500,000 Buy-In

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### Per $100,000

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Given capital gains of 20%, inclusive of State Tax and AMT, and ordinary income rates of 40%, it costs one-third more to purchase stock in after-tax dollars than it does to reallocate compensation. This assumes that the senior doctor actually performs administrative and management services in exchange for the fees paid. **Potential Risk!**
COMPENSATION SHIFT AND ALLOCATION

3. Employee's Compensation.

3.1 Basic Salary. For each consecutive month of the Employment Term, Corporation shall pay Employee a basic salary (herein called the "Basic Salary") equal to any other Officer/professional employee of Corporation. The Basic Salary shall be payable in at least monthly installments and prorated (on a daily basis) if the Employment Term terminates prior to the completion of any monthly period.

3.2 Year-End Bonus. In consideration of Employee's productivity and overall contribution to the benefit of the Corporation, Corporation shall also pay Employee a bonus (herein called the "Year-End Bonus") before the end of each Corporate fiscal year as follows:

(a) The sum of the available bonus pool, as determined by Corporation's Board of Directors;

(b) Add all Basic Salary and advance bonus payments paid to Employee and Dr. _____ for such Corporate fiscal year;

(c) Add all "unique" expenses (as herein defined) paid by Corporation on behalf of Employee and Dr. _____ for such Corporate fiscal year;

(d) Multiply the sum of (a), (b) and (c), above, times a fraction, the numerator of which is Corporation's collections attributable to Employee's rendering of professional dental services for such Corporate fiscal year, and the denominator of which is Corporation's collections attributable to Employee's and Dr. _____'s rendering of professional dental services for such Corporate fiscal year;

(e) Subtract all Basic Salary and advance bonus payments paid to Employee for such Corporate fiscal year; xx[and]xx

(f) Subtract direct business expenses attributable to Employee's employment with Corporation, which direct business expenses include; (i) dental laboratory; (ii) automobile; (iii) travel; (iv) entertainment; (v) continuing education; (vi) retirement plan contributions; and (vii) any other expenses, as determined by the Corporation's Board of Directorsxx[.]xx xx[; and]xx

Figure 11-4

xx[(g) Subtract the Management Fees payable to Dr. _____ under a certain Practice Management Agreement, dated _____, 20__.]xx

The Corporation's Board of Directors may make partial advance payments of bonus from time to time during a Corporate fiscal year based upon Corporation's general cash and financial position. xx[it is determined by Corporation's Board of Directors that the Year-End Bonus is a negative amount, then such negative amount shall be treated as a cash advance by Corporation to Employee which shall be repaid through an offset against Employee's future Basic Salary; provided, however, that upon termination of this Agreement and the Agreement Term, Employee shall immediately repay the cumulative total of any outstanding cash advances. Corporation's Board of Directors may require said advances to be evidenced by a promissory note (in form and substance satisfactory to Corporation).]xx Any Year-End Bonus shall be prorated (on a monthly basis) if the Agreement Term terminated prior to the completion of any Corporate fiscal year.
## Figure 11-5

### BUY-IN METHODS

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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</thead>
</table>
| 1. Stock in after-tax dollars | • No tax risk  
• Simple and straightforward  
• Capital gains to seller  
• Basis to purchaser  
• Security for payment  
• Dr. Junior unaffected by sale of Dr. Senior's stock to a third doctor | • Expensive  
• After-tax dollars to purchaser  
• Contingent and unknown liabilities |

#### 2. Stock excluding goodwill, coupled with compensation shift

Stock excluding goodwill, coupled with purchase of personal goodwill individually.

* An individual's purchase of personal goodwill in place of the compensation shift is not amortizable.

• Inexpensive and affordable for the new owner  
• Potential tax risk  
• Ordinary income to seller  
• Minimal security for payment  
• Second owner affected by senior owner's sale of stock to a third doctor

#### 3. Three entity method

• Amortizable, if practice formed after August 10, 1993  
• Owner flexibility in business expense allocation  
• Dr. Junior unaffected by Dr. Senior's sale of stock to a third doctor  
• Goodwill non-amortizable, if practice formed after August 10, 1993  
• Three tax returns  
• All employees are covered in retirement plan
## Figure 11-6

### BUY-OUT METHODS

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<th>Disadvantages</th>
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<td><strong>1. Stock in after-tax dollars</strong></td>
<td>• Expensive</td>
</tr>
<tr>
<td>• No tax risk</td>
<td>• After-tax dollars to purchaser</td>
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<td>• Simple and straightforward</td>
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<tr>
<td>• Capital gains to seller</td>
<td></td>
</tr>
<tr>
<td>• Basis to purchaser</td>
<td></td>
</tr>
<tr>
<td>• Buy-out made in cash</td>
<td></td>
</tr>
<tr>
<td>• Dr. Junior unaffected by sale of Dr. Junior's stock to a third doctor</td>
<td></td>
</tr>
</tbody>
</table>

| **2. Stock excluding goodwill, coupled with corporation's purchase of personal goodwill or payment of deferred compensation** | • Arguably, capital gains to seller, relative to corporation's purchase of personal goodwill |
| • Deferred compensation inexpensive and affordable to Dr. Junior, but not as beneficial to seller as corporation's payment of personal goodwill | • Potential tax risk — low stock value / purchase and sale of personal goodwill |
| • Buy-out paid in cash, except for deferred compensation                | • Cannot be subject to a restrictive covenant — little security for payment of deferred compensation |

* An individual's purchase of personal goodwill in place of the corporation's purchase or payment of deferred compensation is not amortizable.

| **3. Three entity method**                                               | • Goodwill not amortizable if practice formed before August 10, 1993 |
| • Amortizable if the practice is formed after August 10, 1993            | • Three tax returns                                                   |
| • Owner flexibility for business expense allocation                      | • All employees are covered in retirement plan                        |
| • Dr. Junior unaffected by Dr. Senior's sale of interest to a third doctor |                                                                              |
Figure 11-7

POTENTIAL ISSUES IN FUNDING RETIREMENT PLAN CONTRIBUTIONS WITH ASSOCIATE PROFITS AND COMPENSATION BASED BUY-INS.

1. This mechanism assumes that associate buy-ins can be made as a compensation shift resulting in mostly a pre-tax buy-in. In a C-corporation, the compensation shift could be recharacterized to a non-deductible dividend.

2. The economics of the associate buy-ins are based upon future projections of growth that may or may not occur. The associate/new owner may leave the practice if the future projections of growth are incorrect.

3. What is the facility relocation cost to accommodate the new doctor? Will the existing facility allow for significant increases in revenues and profits?

4. If the retirement plan adopted is a defined benefit plan, significant contributions are mandatory, not optional.

5. Any defined benefit plan will need to be in effect for minimally three years, usually five years. What happens if contributions cannot be made?

6. Human behavior and theoretical outcomes greatly differ. Behavioral change is mandatory to change economic outcomes.

7. Profitability will affect income allocation.

8. Practice owners are being told that they can fund their retirement plan from the efforts of the associate/new owner. The associate/new owner and this individual's advisors may not share the same view.

9. Tax-qualified retirement plans are not for everyone. What about real estate and other investments outside of the retirement plan? This assumes that the doctor has the discipline to save outside of the tax-qualified retirement plan.

10. Practice management is crucial to the success of this mechanism to increase revenues and profitability on a consistent basis. Given the quality, quantity and economic cost of management training, will the doctor(s) change the practice for the better?
COMPENSATION ALLOCATION

Senior Owner

3. **Employee's Compensation.** During the Employment Term, Corporation shall allocate Employee's compensation and any bonuses (collectively the "Basic Salary") as periodically determined by Corporation's Board of Directors and as described in the "Compensation Allocation" in Schedule A, attached herein and incorporated herein by reference.

Corporation's Board of Directors may make partial advance payments of the Basic Salary from time to time during a Corporate fiscal year based upon Corporation's general cash and financial position. If it is determined by Corporation's Board of Directors that the Basic Salary is a negative amount, then such negative amount shall be treated as a cash advance by Corporation to Employee which shall be repaid through an offset against Employee's future Basic Salary; provided, however, that upon termination of this Agreement and the Agreement Term, Employee shall immediately repay the cumulative total of any outstanding cash advances. Corporation's Board of Directors may require said advances to be evidenced by a promissory note (in form and substance satisfactory to Corporation). Any Basic Salary shall be prorated (on a monthly basis) if the Agreement Term terminated prior to the completion of any Corporate fiscal year.

New Owner

3. **Employee's Compensation.** During the Employment Term, Corporation shall allocate Employee's compensation and any bonuses (collectively, the "Basic Salary") as periodically determined by Corporation's Board of Directors and as described in the "Compensation Allocation" in Schedule A, attached hereto and incorporated herein by reference. Notwithstanding the foregoing, Employee's Basic Salary shall be reduced and offset by the Management Fees payable to Dr. __________ under a certain Practice Management Agreement of even date, between Corporation and Dr. __________.

Corporation's Board of Directors may make partial advance payments of the Basic Salary from time to time during a Corporate fiscal year based upon Corporation's general cash and financial position. If it is determined by Corporation's Board of Directors that the Basic Salary is a negative amount, then such negative amount shall be treated as a cash advance by Corporation to Employee which shall be repaid through an offset against Employee's future Basic Salary; provided, however, that upon termination of this Agreement and the Agreement Term, Employee shall immediately repay the cumulative total of any outstanding cash advances. Corporation's Board of Directors may require said advances to be evidenced by a promissory note (in form and substance satisfactory to Corporation). Any Basic Salary shall be prorated (on a monthly basis) if the Agreement Term terminated prior to the completion of any Corporate fiscal year.
Figure 11-8

SCHEDULE A

Compensation Allocation

For each consecutive month of the Employment Term, Employee shall be entitled to Basic Salary equal to: (a) the monthly collected revenues attributable to professional dental services rendered to Corporation's Patients by Employee; (b) less fifty percent (50%) of Corporation's fixed overhead expenses (prorated on a monthly basis); (c) less fifty percent (50%) of Corporation's variable overhead expenses (prorated on a monthly basis); and (d) less all direct business expenses (prorated on a monthly basis) incurred by Corporation and attributable to Employee's aforementioned professional dental services on behalf of Corporation, which monthly collected revenues, fixed expenses, variable expenses, and direct business expenses shall be determined by Corporation's accountant and approved by Corporation's Board of Directors.
### Figure 11-9

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<td>.3 = 50%</td>
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<td>Practice Revenue</td>
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<td>.4</td>
<td>.6</td>
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</table>

Over time, Dr. Junior rarely produces more than Dr. Senior. In other words, the percentages change very little over 20 years.

In a solo group, some expense categories will be equally allocated and some on the basis of productivity or collected revenue. However, each practice pays its own staff (with some sharing), supplies (except for common supplies), lab, direct business expenses, insurances and benefits.

Where the practice pays the Overhead, each owner is allocated compensation equal to the respective owner's collections, multiplied by the Available Compensation Percentage.
### Figure 11-10

<table>
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<tr>
<th>Category</th>
<th>Dr. Senior</th>
<th>Dr. Junior</th>
<th>Dr. Senior</th>
<th>Dr. Junior</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Practice Revenue</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2. Overhead</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
</tr>
<tr>
<td>3. Available Compensation</td>
<td>$ 800,000</td>
<td>800,000</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>4. Doctor Revenue</td>
<td>x .6</td>
<td>x .4</td>
<td>1,200,000</td>
<td>800,000</td>
</tr>
<tr>
<td>5. Overhead</td>
<td>N/A</td>
<td>N/A</td>
<td>-600,000</td>
<td>-600,000</td>
</tr>
<tr>
<td>6. Doctor Compensation</td>
<td>$ 480,000</td>
<td>320,000</td>
<td>600,000</td>
<td>200,000</td>
</tr>
<tr>
<td>7. Doctor Compensation as Percentage of</td>
<td>$ 480,000</td>
<td>320,000</td>
<td>600,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Available Compensation</td>
<td>= 60%</td>
<td>= 40%</td>
<td>= 75%</td>
<td>= 25%</td>
</tr>
<tr>
<td>8. Doctor Compensation as a Percentage of</td>
<td>$ 800,000</td>
<td>800,000</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Practice Revenue</td>
<td>$ 480,000</td>
<td>320,000</td>
<td>600,000</td>
<td>200,000</td>
</tr>
<tr>
<td>9. Doctor Compensation as a Percentage of</td>
<td>$ 1,200,000</td>
<td>800,000</td>
<td>1,200,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Practice Revenue</td>
<td>= 40%</td>
<td>= 40%</td>
<td>= 50%</td>
<td>= 25%</td>
</tr>
</tbody>
</table>
# Figure 11-13

<table>
<thead>
<tr>
<th>Category</th>
<th>Dr. Senior</th>
<th>Dr. Junior</th>
<th>Dr. Senior</th>
<th>Dr. Junior</th>
</tr>
</thead>
<tbody>
<tr>
<td>Practice Pays Overhead</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Practice Revenue</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2. Overhead</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
</tr>
<tr>
<td>3. Available Compensation</td>
<td>$ 800,000</td>
<td>800,000</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>4. Doctor Revenue x .55</td>
<td>x .55</td>
<td>x .45</td>
<td>1,100,000</td>
<td>900,000</td>
</tr>
<tr>
<td>5. Overhead</td>
<td>N/A</td>
<td>N/A</td>
<td>-600,000</td>
<td>-600,000</td>
</tr>
<tr>
<td>6. Doctor Compensation</td>
<td>$ 440,000</td>
<td>360,000</td>
<td>500,000</td>
<td>300,000</td>
</tr>
<tr>
<td>7. Doctor Compensation as Percentage of Available Compensation</td>
<td>$ 440,000 = 55%</td>
<td>360,000 = 45%</td>
<td>500,000 = 62.5%</td>
<td>300,000 = 37.5%</td>
</tr>
<tr>
<td></td>
<td>$ 800,000</td>
<td>800,000</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>8. Doctor Compensation as a Percentage of Practice Revenue</td>
<td>$ 440,000 = 40%</td>
<td>360,000 = 40%</td>
<td>500,000 = 45.45%</td>
<td>300,000 = 33.3%</td>
</tr>
<tr>
<td></td>
<td>$1,100,000</td>
<td>900,000</td>
<td>1,100,000</td>
<td>900,000</td>
</tr>
</tbody>
</table>

### Figure 11-14

<table>
<thead>
<tr>
<th>Category</th>
<th>Dr. Senior</th>
<th>Dr. Junior</th>
<th>Dr. Senior</th>
<th>Dr. Junior</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Practice Revenue</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2. Overhead</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
<td>-1,200,000</td>
</tr>
<tr>
<td>3. Available Compensation</td>
<td>$800,000</td>
<td>800,000</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>4. Doctor Revenue</td>
<td>x .5</td>
<td>x .5</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>5. Overhead</td>
<td>N/A</td>
<td>N/A</td>
<td>-600,000</td>
<td>-600,000</td>
</tr>
<tr>
<td>6. Doctor Compensation</td>
<td>$400,000</td>
<td>400,000</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>7. Doctor Compensation as Percentage of Available Compensation</td>
<td>$400,000 = 50%</td>
<td>400,000 = 50%</td>
<td>400,000 = 50%</td>
<td>400,000 = 50%</td>
</tr>
<tr>
<td>8. Doctor Compensation as a Percentage of Practice Revenue</td>
<td>$400,000 = 40%</td>
<td>400,000 = 40%</td>
<td>400,000 = 40%</td>
<td>400,000 = 40%</td>
</tr>
</tbody>
</table>
JOHN SMITH, D.D.S., P.A.

ACTION BY SHAREHOLDER
IN WRITING
WITHOUT A MEETING

The undersigned, being the sole Shareholder of JOHN SMITH, D.D.S., P.A. (herein called the "Corporation"), does hereby take and adopt the following actions, in writing and without a meeting, pursuant to the authority of Section 607.0704 of the Florida Business Corporation Act:

RESOLVED that these Minutes are hereby deemed to constitute the Annual Meeting of the Shareholder for the year 20__.

RESOLVED, FURTHER, that the following persons are hereby elected as Directors of Corporation to serve until their successors are elected at the next Annual Shareholder's Meeting, or until their earlier resignation, disqualification, removal from office or death:

    John Smith, D.D.S.
    Susan A. Smith

RESOLVED, FURTHER, that the Shareholder hereby approves Corporation's Financial Statements from and since the last Annual Shareholder's Meeting, which Financial Statements satisfy the requirements of Section 607.1620 of the Florida Business Corporation Act.

RESOLVED, FURTHER, that all acts, transactions and business of the Directors and Officers from and since the last Annual Shareholder's Meeting hereby are fully ratified, approved and confirmed.

                      John Smith, D.D.S.

December 8, 20__

JOHN SMITH, D.D.S., P.A.

ACTION BY DIRECTORS
IN WRITING
WITHOUT A MEETING

The undersigned, being all of the Directors of JOHN SMITH, D.D.S., P.A. (herein called the "Corporation"), do hereby take and adopt the following actions, unanimously in writing and without a meeting, pursuant to the authority of Section 607.0821 of the Florida Business Corporation Act:

RESOLVED that these Minutes are hereby deemed to constitute the Annual Meeting of the Directors for the year 20__.

RESOLVED, FURTHER, that the following persons are hereby elected as Officers of Corporation to serve until the next Annual Directors' Meeting immediately following the Annual Shareholder's Meeting and until their successors are elected thereat, or until their earlier resignation, disqualification, removal from office or death:

   President/Treasurer - John Smith, D.D.S.
   Secretary - Susan A. Smith

RESOLVED, FURTHER, that the Directors hereby approve Corporation's Financial Statements from and since the last Annual Directors' Meeting, which Financial Statements satisfy the requirements of Section 607.1620 of the Florida Business Corporation Act.

RESOLVED, FURTHER, that all acts, transactions and business of the Directors and Officers from and since the last Annual Directors' Meeting hereby are fully ratified, approved and confirmed.

John Smith, D.D.S.

Susan A. Smith

December 8, 20__
### FOR-PROFIT YEAR-END MATTER INFORMATION SHEET

**NAME OF CORPORATION** John Smith, D.D.S., Inc.  
**FISCAL YEAR ENDING** December 31, 20__

**CLIENT NO.** 9999.001

---

(A) **DIVIDENDS:**
- Date Declared:  
- Amount Per Share: $  
- Date Paid:  
- Total Amount Paid: $  

(B) **PROFIT-SHARING:** Total Amount (or percentage) contributed to Plan: $  %  

(C) **TOTAL COMPENSATION** (Basic Salary PLUS all bonuses) paid to key, management employees (Shareholders, Directors, Officers) during the fiscal year:

<table>
<thead>
<tr>
<th>Name of Employee</th>
<th>Basic Salary (According to Employment Agreement)</th>
<th>TOTAL Bonuses Paid*</th>
<th>If Accrual Basis</th>
<th>TOTAL COMPENSATION</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

*Please also list bonuses in Item (D), below:

(D) **BONUSES:** All other employees. (Please attach additional sheets, if necessary)

<table>
<thead>
<tr>
<th>Name of Employee</th>
<th>Bonus Paid</th>
<th>Date Paid</th>
<th>Bonus Accrued</th>
<th>Date Accrued</th>
<th>Was this a Holiday Season Bonus?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td>No ___ Yes ___</td>
</tr>
<tr>
<td></td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td>No ___ Yes ___</td>
</tr>
<tr>
<td></td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td>No ___ Yes ___</td>
</tr>
<tr>
<td></td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td>No ___ Yes ___</td>
</tr>
<tr>
<td></td>
<td>$</td>
<td></td>
<td></td>
<td></td>
<td>No ___ Yes ___</td>
</tr>
</tbody>
</table>

(E) **SALARY INCREASES:**

<table>
<thead>
<tr>
<th>Name of Employee</th>
<th>Effective Date</th>
<th>Old Salary</th>
<th>New Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td></td>
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<td>$</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

**Figure 11-16**

_____ (F) **MAJOR CORPORATE CAPITAL EXPENDITURES:** (Over $5,000.00)**

<table>
<thead>
<tr>
<th>Item</th>
<th>Date Purchased</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**(Note — If item purchased/sold was an automobile, list whether it was (a) purchased, or (b) sold, total purchase/sale price, date purchased/sold, year and make of car, indicate if car is for Corporate use only (or the particular person that will be using car) and give details (if applicable) for financing, (e.g., financing institution, amount borrowed, date borrowed, interest rate and payment schedule).**

_____ (G) **SEMINARS AND CONVENTIONS ATTENDED:**

<table>
<thead>
<tr>
<th>Date Attended</th>
<th>Date Expenses PAID</th>
<th>Place</th>
<th>Subject</th>
<th>Attendees</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

_____ (H) **MISCELLANEOUS TRANSACTIONS** (e.g., institution of benefit plans (e.g. Medical, Group-Term Life, Disability, Employee Expense Reimbursement Accountability), real estate or equipment leases, amendments to the Articles of Incorporation or Regulations, fiscal year changes, statutory agent changes, change of business address, charitable contributions, directors' fees, membership dues, reimbursement of expenses, etc.) Please give important details (e.g. date, amounts, etc.).

_____ (I) **Management Fees Paid In Exchange For Management Services Rendered.**

_____ (J) **No change in Officers and/or Directors (check if applicable).**

_____ (K) **If (I), above, not checked, then please list Officers and/or Directors.**

President: ____________________ Secretary: ____________________

Vice-President: ____________________ Treasurer: ____________________

Vice-President: ____________________ Other (if any): ____________________

Directors: ____________________

## Figure 11-17

### BUY-SELL AGREEMENT MATRIX

<table>
<thead>
<tr>
<th>Contract Terms</th>
<th>Nature of Parties' Obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Price (a)</td>
<td>Practice/Remaining Owner(s) Must Buy</td>
</tr>
<tr>
<td>Payment Terms (b)</td>
<td>Practice/Remaining Owner(s) have Option to Buy</td>
</tr>
<tr>
<td>Purchase of Insurance (c)</td>
<td>Departing Owner Must Sell</td>
</tr>
<tr>
<td>Departing Owner has Option to Sell</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Triggering Events</th>
<th>Purchase Price Options:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Death</td>
<td>1. Stock In After-Tax Dollars</td>
</tr>
<tr>
<td>Permanent Disability</td>
<td>2. Stock Excluding Goodwill, Coupled With Corporation's Payment of Personal Goodwill or Payment of Deferred Compensation.</td>
</tr>
<tr>
<td>Election to Transfer by Owner</td>
<td>3. Three Entity Method</td>
</tr>
<tr>
<td>Termination of Owner's Employment</td>
<td></td>
</tr>
<tr>
<td>Retirement</td>
<td></td>
</tr>
<tr>
<td>Dispute</td>
<td></td>
</tr>
</tbody>
</table>

(a) **Purchase Price Options:**
1. Stock In After-Tax Dollars
2. Stock Excluding Goodwill, Coupled With Corporation's Payment of Personal Goodwill or Payment of Deferred Compensation.
3. Three Entity Method

(b) **Payment Term Options:**
1. Cash
2. Promissory Note
3. Cash Down Payment and Promissory Note

(c) **Purchase of Insurance to Fund Obligation:**
1. Life Insurance
2. Disability Buy-Out Insurance

Schedule E

CORPORATE SHARE VALUE IN THE EVENT OF TERMINATION OF EMPLOYMENT

The value of the Corporate Shares of a Terminated-Shareholder shall equal: (a) the fair market value of Corporation's dental equipment, office equipment and furniture (herein called the "Tangible Assets") determined by (i) the net book value of the Tangible Assets as of the date of purchase, plus (ii) one-third (1/3) of the depreciation previously taken by Corporation on the Tangible Assets as of the Purchase Date; plus (b) the fair market value of Corporation's dental supplies determined by (i) the sum of the dental supplies purchased by Corporation for the most recent twelve (12) months immediately preceding the Purchase Date, and (ii) divided by twelve (12) months, and (iii) multiplied by three (3) months; plus (c) the fair market value of dental instruments determined by (i) the sum of Corporation's billed and collected revenues for the most recent twelve (12) months immediately preceding the Purchase Date, and (ii) multiplied by one-half percent (1/2%); plus (d) _________ percent (____%) of Corporation's accounts receivable on the Purchase Date; less (e) Corporation's long-term debt on the Purchase Date; and (f) the sum of (a) through (e) multiplied by a percentage, the numerator of which is the percentage of the Corporate Shares owned by the Terminated-Shareholder, the denominator of which is the number of Corporate Shares owned by all Shareholders.

________________________________________________________________________

[Dr. 1] xx

________________________________________________________________________

[Dr. 2] xx

________________________________________________________________________

[Dr. 3] xx

-Shareholders-

[PROFESSIONAL CORPORATION] xx

By: ____________________________________________

[Dr. 1] xx, President

And: ____________________________________________

[Dr. 2] xx, Vice-President

And: ____________________________________________

[Dr. 3] xx, Vice-President

-Corporation-

_________________________, 20__
Figure 11-19

Schedules A, B, C, D, E

AGREED SHARE VALUE

The value of each Corporate Share of a Deceased, Disabled, Electing, Terminated or Retiring-Shareholder shall equal _______________ Dollars ($________). 

Corporate Share Values May Vary According To The Triggering Event

______________________________
xx[Dr. 1]xx

______________________________
xx[Dr. 2]xx

______________________________
xx[Dr. 3]xx

–Shareholders–

xx[PROFESSIONAL CORPORATION]xx

By: __________________________
xx[Dr. 1]xx, President

And: _________________________
xx[Dr. 2]xx, Vice-President

And: _________________________
xx[Dr. 3]xx, Vice-President

–Corporation–

__________________________, 20___
FORMULA SHARE VALUE IN THE EVENT OF DEATH, PERMANENT DISABILITY, ELECTION TO TRANSFER, OR RETIREMENT

The value of the Corporate Shares of a Deceased, Disabled, Electing or Retiring-Shareholder shall equal: (a) the sum of Corporation's billed and collected gross revenues for the fiscal year immediately preceding the fiscal year in which a Shareholder's Death, Disability, Election to Transfer, or Retirement occurs; (b) multiplied by ____________%; and (c) multiplied by a percentage, the numerator of which is the percentage of the Corporate Shares owned by the Deceased-Shareholder, Disabled-Shareholder, Electing-Shareholder, or Retiring-Shareholder, and the denominator of which is the number of Corporate Shares owned by all Shareholders.

Separate Schedule for Termination of Employment

___________________, 20___
LIQUIDATION VALUE

The Liquidation Value of the Company on the Valuation Date shall equal the most recent appraisal of Company's dental practice completed by __________ or any appraiser designated by the Members.
Chapter 12

WHY SOLO GROUP ARRANGEMENTS MAKE SENSE

Solo group arrangements for general practices and some specialties are an underutilized alternative to co-ownership. These arrangements were invented in approximately 1979 by Dr. James R. Pride, founder of Pride Institute. In co-ownership, it is essential that Dr. Junior buy the first and second half of Dr. Senior's practice. Assuming that Dr. Junior is practicing at full capacity after purchasing the first half of Dr. Senior's practice, Dr. Junior may not (probably will not) want to be obligated to buy the second half of Dr. Senior's practice. A solo group arrangement solves this problem because Dr. Senior and Dr. Junior maintain separate practices in the same facility and there is no mandatory buy-out of Dr. Senior by Dr. Junior, except maybe for the death or disability of a solo group member.

Associate Employment Arrangement

Dr. Junior joins your practice as an associate dentist just as Dr. Junior would in co-ownership. And identical to and under the same timing as becoming a co-owner in your practice, Dr. Junior purchases 50% or an undivided half interest of your tangible assets and an undivided 50% interest in your personal goodwill. But rather than being co-owners, you and Dr. Junior maintain separate practices under an office sharing arrangement. In addition to resolving the problem of Dr. Junior not necessarily wanting to purchase the second half of your practice, although Dr. Junior would retain the option to do so, the harsh anti-churning rules under IRC Section 197 are avoided if your practice was formed before August 10, 1993 because there is no common ownership of a third entity under the three entity method of co-ownership, assuming that the doctors are not family members.

Buy-Out

If Dr. Junior will not agree to be obligated to buy you out in co-ownership, your interest is almost worthless. In co-ownership, Dr. Three must work with Dr. Junior and Dr. Junior will want to retain founder's rights above Dr. Three. This makes it difficult to get Dr. Three to buy-out your interest. And because Dr. Junior will not guarantee Dr. Three's loan, you are paid over time.

In a solo group, your practice can be sold to a third party if Dr. Junior does not exercise his or her option to make the purchase within a short notice period. This is because Dr. Three is not required to become co-owners with Dr. Junior and maintains a separate practice.

Office Sharing Agreement

Each practice operates its, his or her dental practice separately in the same facility and employs its, his or her staff, to the extent not shared, and bills its own patient and pays its own operating expenses. Each practice operates its, his or her practice under an office sharing
agreement in accordance with pre-determined common policies and expense sharing allocations that would be equally shared or allocated based upon collections of one solo group member as a percentage of all solo group members. An example of the key terms of an office sharing agreement is designated in Figure 12-1.

**Buy-Sell Agreement**

A buy-sell agreement would be in place granting the option of a solo group member to purchase the practice of a retiring solo group member. If the option is not exercised in a short time, the retiring solo group member may sell its, his or her practice to any dentist licensed in the applicable state under the terms of the office sharing agreement and buy-sell agreement. If Dr. Junior would desire and be required to leave the premises in the event of a dispute, the buy-sell agreement would provide that Dr. Junior would be permitted to remove Dr. Junior's patient charts, retain Dr. Junior's telephone number, website(s) and domain name(s) and remove Dr. Junior's personal property, dental equipment and technology. Dr. Junior would also receive the fair market value of any jointly owned equipment and technology as determined by a formula in the buy-sell agreement. Dental supplies and instruments would also be considered in this formula if shared, but are usually owned by the respective practices.

**Shared Employees**

In a solo group, each practice can share employees. One practice may share hygienist(s) or front desk personnel. While in a general practice hygiene can be shared, I do not like sharing front desk personnel due to scheduling priorities. Typically, Dr. Senior's practice pays the shared staff to the extent worked for Dr. Junior's practice and Dr. Junior's practice reimburses Dr. Senior's practice for the pro-rata cost.

**Retirement Plans and Health Insurance**

Unlike the three entity method of co-ownership, solo group arrangements permit the practices to maintain separate retirement and health plans. To the extent that employees are shared, the prorated benefits are reimbursed by Dr. Junior's practice or Dr. Senior's, or vice-versa. This is significant because Dr. Senior and Dr. Junior may have significant differences in retirement and health plan design.
## SOLO GROUP ARRANGEMENTS

### OFFICE SHARING AGREEMENT PROVISIONS

1. Management of the facility, decision making procedures, and dispute resolution provisions.
2. Work schedules and use of the facility.
3. Joint and individual checking accounts.
4. Division of expenses either shared equally or based upon respective practice productivity.
5. Facility maintenance.
7. Sharing of certain staff members as well as payment of staff compensation, fringe benefits and retirement plan contributions.
8. Confidentiality of patient records and/or referral sources.
9. Use of telephone lines.
10. Mutual indemnification or hold harmless provisions.
11. Maintenance of current license to practice the doctor's profession.
12. Responsibility for repair of the premises other than equipment.
13. Capital and cash contributions.
14. Requirements to sublet or assign space, as well as the process to hire or engage an associate doctor.
15. Termination provisions.
16. Miscellaneous provisions, e.g., an integration clause whereby the document contains the entire agreement relative to the subject matter, possible arbitration in the event of a dispute, jurisdiction and venue provisions, changes to the agreement must be in writing.
17. Maintenance of malpractice/liability insurance with specific coverage limits.
18. Any individual or entity who or which acquires the practice of a retiring or departing practice owner may be required to become a party to the Office Sharing Agreement as a condition to the practice sale.
19. The dates, time and place of respective practice owner meetings to discuss common agenda items and business.
20. Real Estate and Lease commitments — who stays and who leaves in the event of a dispute.

SUMMARY AND THOUGHTS FOR THE FUTURE

If you are leaving practice, start planning early, understand your exit choices and depart on your terms. The more time you have, the better you can plan. A complete sale of assets is simple and beneficial from a tax perspective because you receive mostly capital gains and the purchaser can amortize or deduct the entire purchase price. If you plan to work for up to seven years, hiring an associate with a complete sale in one to three years is perfect for a large or unique practice that requires purchaser mentorship. With enough production, you can work three or four years after the sale and by mutual agreement thereafter. Co-ownership only works where Dr. Junior commits to purchasing the second half of your practice. Three or more owner practices, while rare, result in buy-outs paid over time, as opposed to being paid in cash. Solo groups are a good alternative to co-ownership because there is no mandatory buy-out of the second half of your practice. The purchaser can also deduct the assets purchased, with limited exceptions. Mergers with contingent sales work well for practices that are otherwise not saleable. Finally, working for one or two more years, then closing the doors, has some merit.

If you are entering practice, you have an additional choice in that you can establish a practice. Dentists and specialist who establish a practice usually do so out of frustration of other practice entry options not working out or they are from the geographic area where they plan to practice. This takes 30 patients per month and another job. If you are entering into co-ownership, request a signing bonus to pay advisors in these complex transactions. Sign a confidentiality letter and insist on understanding the valuation, valuation date and business and tax structure of the co-ownership before signing an employment agreement containing a restrictive covenant. As to restrictive covenants, you need the ability to work without relocating should the opportunity fail.

For those of you leaving or entering practice, live your dreams! If you can dream it, you can do it. While it may take time, don't compromise, at least not in the long run. Compromise starts with the lack of or faulty information on your practice exit or entry choices. The more you and your advisors know, the less you need to compromise.