Who's the boss?

The cash and stock options offered by DSMCs sound nice enough, but is a buy-out right for you? Do you really want to ask some young hotshot if you can play golf this afternoon?

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Much is being said today about roll-up companies, also known as dental management service companies. We've all heard about the buy-outs, stock options and the freedom to do dentistry for a fixed salary while letting someone else manage the operation of the dental office. Sound like manna from heaven? It could be. But, before you jump on the band wagon, you've got to determine whether such an arrangement is right for your personal and professional goals. There are more than 40 dental-management service companies (DMSCs) trying to buy practices today. The lure for the dentist is that 25 to 30 percent of the practice purchase price is cold, hard, cash; the rest is a promissory note and stock or stock options, which the dentist envisions being worth millions some day. Unfortunately, it's not quite that simple.

Nonetheless, we've all heard the get-rich-quick stories, and there have been some viable successes. So let's assume you're interested in finding out more about joining forces with a DMSC.

Basically, there are two types of buy-outs offered. Both involve cash and stock or stock options, with the difference being the inclusion of a promissory note for part of the buy-out. The most common purchase agreement allows for an amount of cash to be paid to the dentist, based on one-quarter or one-third of last year's revenue from the dental practice that is being sold. In other words, the seller would receive cash in the amount of $100,000 to $200,000 plus, depending on revenues. In addition, the purchase agreement typically will include a promissory note paid at a stipulated amount of interest over the next five years or longer. Finally, there is either an option to buy stock at a preferred rate in the DMSC that is purchasing the practice or receipt of a certain amount of shares in the company that has gone public or promises to go public. Occasionally, a DMSC will pay cash in full at closing in order to gain entry into a particularly lucrative geographic market, but this not the norm.

In a typical DMSC-acquisition proposal for a combina-

tion of some cash and stock, the practice owner who has the least risk in selling to a DMSC is one who has significantly funded his or her retirement plan. He or she has socked away at least $1 million and will be able to live off the principal and interest comfortably for 25 or more years and, therefore, is not dependent upon the receipt of practice proceeds at retirement. If the stock does well, the retiring seller receives a windfall. If the DMSC does not perform to expectations, little is lost because the practice has secured the dentist's retirement prior to the buy-out. On the other side of the coin, the mid-career dentist with little savings, particularly one who must work for the DMSC after the sale and pay management fees back to the DMSC, probably should not risk speculation with DMSC stock as part of a buy-out agreement. Unfortu-nately, it is the latter who sees the DMSC route as the easy answer to an unfunded retirement plan.

With these situations in mind, let's look at a few of the questions that you need to ask before agreeing to sell your dental practice to a DMSC. First, how many years has it taken you to build the dental practice and at what price? Is the one-time, cash-in-hand payment enough to cover the investment you've made if the stock options fail? How many years have you been profitable to the tune of at least $130,000 or more, pre-tax? Are you prepared to walk away from this year-to-year sure deal for a one-time cash-in-hand payment of approximately the same amount? Should you decide, after the fact, that you do not wish to work as an employee of the buy-out company, how much effort will be required to build a practice from the ground up again?

Are you prepared to do the necessary due diligence as the seller? Because you are probably dealing with a relatively new entity that will probably be publically traded, it is critical to assess and analyze all information that normally would be addressed with respect to selling your practice to a public company. This is much different and more difficult than assessing the credentials of an individual purchaser. Obtain every piece of information that you can on the DMSC. Check all references as to the management team and investors, their backgrounds and dental experiences. The typical information you receive from the DMSC naturally will be DMSC-friendly, focusing on the company's goals and objectives, which may or may not materialize. Ask the DMSC to provide, in writing, its track

When someone else is the boss...

How do you feel about becoming an employee? Some dentists would relish the opportunity to go to work, be paid a salary and leave at the end of the day without any worries. If this sounds appealing, then an arrangement with a DMSC might prove rewarding. If you desire freedom in the way you practice, it may be difficult to become an employee and have to answer to corporate headquarters if your production is low, or if you need to take extra time off. As a typical condition of the sale, the DMSC requires you to remain in its employ for five years in some cases, to as long as 30 years in others. These companies cannot purchase your dental license. They purchase only the assets of the practice, including the patient records and your patients' good will. Therefore, you'll be needed to do the dental work. Who is going to be in charge of you? Is it another dentist that the DMSC will bring in to work with you? Is it another dentist at another site? Is it someone from the company's headquarters?

Who decides what type of treatment will be offered to patients? Some DMSCs state that they are only buying high-quality practices. Who defines "high-quality," the dentist or the DMSC? Will the dentist be asked to restrict the type or the frequency of treatment delivered? Will the dentist be told that, from this point forward, prophylaxes will be 30 minutes or will the dentist be allowed to practice the way he or she was practicing before the buy-out? Know what you are getting into. If the word "capitation" appears anywhere in the operating agreement, you can bet this will be a factor, either now or in the future.

Who determines practice hours? Initially, the hours of work may seem extremely favorable. But read the contract carefully. Usually, the operating agreement can be changed "to make the company more profitable or more competitive." Suddenly, some dentists will find that they are being asked to work evenings, Saturdays or longer work days. For dentists who are over 50 years old and have been practicing independently for some 20 years, it may be difficult to come to terms with the fact that they have a total of two weeks' vacation and that their hours are controlled by someone else.

Who manages the staff? Most DMSCs promise to take staff management off the shoulders of the dentist. Most dentists would like to be freed from the tasks of motivating, training and compensating staff. Several agreements have stated explicitly that while the company will send in consultants and other individuals from time-to-time to oversee and manage the staff, it is, in fact, the dentist's responsibility to hire, fire, train and motivate staff members who work with him or her on a regular basis. If the company sets a work rule that the staff doesn't care for, the unhappy staff member(s) go to the dentist, not the company, for the mediation of work rules. While one of the motivations for selling in the first place may be to get away from the challenges of staff management, most DMSC agreements ask the dentist to deal with these issues.

Sale may be a breath of fresh air, but what about taxes?

What are the tax consequences of the sale once you have succumbed to the great lure of getting that initial $150,000 to $200,000 in cash? How much will the taxes be and how much will be left? What are the tax consequences if you have to buy the practice back? Can you regain the taxes that you already had paid when you originally sold? Assuming you have an independent, qualified pension plan, how much of that money can you use to fund retirement?

Some DMSCs contend that the sale of your practice can be accomplished on a tax-free basis. There are two ways to sell a practice or any business: through the sale of assets or through the sale of stock.

In the event that your practice operates as a C corporation and the DMSC agrees to acquire the stock of your practice, the sale of your stock may be classified as an Internal Revenue Code Section 168 reorganization. In this situation, gain may be deferred to the extent that your stock was exchanged for DMSC stock. However, any increase in the value of the DMSC stock after the sale of the stock of your practice would be taxable upon its later sale.

A more likely scenario is that the DMSC would agree to acquire the assets of your practice. Therefore, if your practice operates as a C corporation and sells its assets, there are two levels of tax imposed: 35 percent at the corporate level and another tax at the selling dentist's individual tax rate. In essence, there can be well over a 55 percent tax rate when a professional C corporation sells its assets.

Practices operating other than as C corporation entities do not face double taxation upon the sale of assets. The tax implications of any practice sale should carefully be considered while any management, consulting and deferred compensation arrangements should be handled in accordance with applicable federal tax regulations.

At the state and federal levels, there can be certain considerations relative to selling your practice to a DMSC. They include:

- Fee-splitting concerns since you are, in essence, "splitting" the fee with the DMSC.
- The fact that some states question whether a DMSC is engaged in the unauthorized practice of dentistry.
- Whether the unbundling of fees poses a problem under both federal antitrust law and applicable state insurance laws.

These matters, and others, should be reviewed and addressed prior to selling your practice to a DMSC.

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record for attaining these goals. All Securities and Exchange Commission filings and documents pertaining to the DMSC should be obtained and reviewed as well. All of this documentation should be scrutinized prior to releasing any information on your practice. Thereafter, sign a confidentiality agreement with the DMSC, whereby information with respect to your practice will not be used against you in the event that you do not sell your practice to the DMSC. Distinguish the confidentiality agreement from a letter of intent, which outlines the terms and conditions of the sale of your practice. Unless you are absolutely certain that you desire to negotiate with only one DMSC, be cautious in granting an exclusive right to negotiate for a specified time period. Any letter of intent should be drafted as a non-binding proposal, subject to the execution of definitive legal documents. In other words, do not allow a letter of intent to have more meaning than you intend. After the sale, your due diligence continues. You will have to assure that you are being paid the full purchase price when due; you will have to provide any required management fees to the DMSC after the sale and, typically, you will remain in the practice as an employee of the DMSC for some period of time.

Read the fine print

Like any other business, DMSCs are in business to make money. Before entering into any agreement to sell, be sure you understand all of the fine print of the contract and your long-term obligations to the company. Most agreements call for you to provide the DMSC with "management fees." Some fees range from 14 to 20 percent or more of yearly collections. Others call for up to 30 percent of the pre-tax net before owner's compensation. Either way, it can add up to a hefty sum. The DMSC has to realize a return on its investment. If it has put $150,000 into the practice, it will need a 15 to 25 percent return on that investment each year. If the DMSC invests $500,000 into the practice, under the buy-out terms it will need to recoup an investment return of $70,000 or $80,000. Additionally, the DMSC has to have its general and administrative expenses paid: salaries for its CEO, president, chief operating officer, chief financial officer, secretaries, etc. Also, included in these expenses is the money for the trainers and consultants the DMSC brings into the practice "from time-to-time."

Finally, the DMSC has to assure that it has built profit into its bottom-line so that the company's stock value can appreciate. This money has to come out of what used to be called the dentist's pre-tax, take-home pay. Therefore, to receive your anticipated compensation and to assure that the stock is viable so that you can ultimately realize the full purchase price

for your practice, profitability must increase at a rate equal to these management fees.

Many DMSCs state they increase the pre-tax net of the dental practice by reducing supply costs through bulk inventories. In fact, a 25 percent reduction in supply costs would add only about 1.5 percent to the bottom line. That's only $7,000 to the bottom line of a $500,000 practice.

DMSCs may extend the hours of operation to reduce facility costs and the amortization of dental equipment costs, and may move two or three practitioners into a one-dentist office. There is some validity to this concept from a business perspective. There is no sense in having a dental practice sit idle weekends or evenings. The question is, how many dentists with how many different personalities will be brought together in order to accomplish the cost reductions? What control, stipulated in writing, do you have over these issues?

Terminating an agreement

Let's look at what can happen if the arrangement *doesn't* work out as anticipated. In most cases, the dentist electing to terminate the operating agreement will walk away from the promissory note and, more than likely, walk away from the option to purchase stock or the stock that he or she holds. The fine print is very important here. The dentist who doesn't like the DMSC and doesn't like being an employee, may have to walk away from his or her practice with $150,000 or $200,000, and that's it.

On the other hand, many agreements allow the dentist the option of buying back the practice. Be careful here, too, to avoid paying more to get the practice back than you originally got in cash for selling it. There usually are substantial penalties attached to practice buy-backs. Certainly, you would want your practice back if you were not yet retired. Therefore, any covenant not to compete should be null and void under certain negotiated circumstances. Additionally, the DMSC should be subject to a non-compete in the event that you reopen your practice. Further, you should have the ability to re-enter the premises under any lease (whether you own the building or not), if necessary. Finally, you should have a "first security interest" on the practice assets or stock that you sold to the DMSC.

When a substantial part of the sale of the practice is tied to the sale of the stock and the company does not go public, where does that leave the dentist? Possibly selling the practice for less money than it is worth because part of the sale price is tied to the stock of the DMSC. Additionally, public stock cannot be sold until a DMSC goes public. Assuming a public offering is successful, do not expect to sell your DMSC stock quickly. The Securities and Exchange Commission

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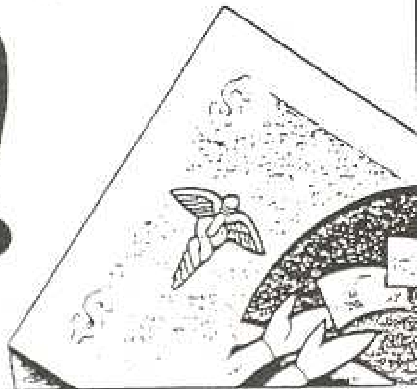

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usually mandates a two-year holding period prior to such stock being sold.

Because DMSCs constitute relatively new ground on Wall Street, expect the Securities and Exchange Commission to impose additional restrictions. In the future, selling your practice and owning stock in a DMSC may become more complex.

In the event that a DMSC is unsuccessful, it can file bankruptcy, close its doors, be merged or sold. In the event of bankruptcy, what are the responsibilities of the dentist? What are the dentist's chances of being paid on the promissory note? At this point, the stock options become a mute point. In the event the DMSC is sold to or merged with another company, what are the dentist's rights in the new arrangement? Your continued obligations under these circumstances should be considered and negotiated prior to your selling in the first place. For example, you may be very happy with your arrangement with a DMSC. However, if it is merged with another company or is sold, there may be new management and operational systems to contend with. As a result, you could be very unhappy with the new arrangement and wish to terminate your employment, be paid all sums due you immediately, take your practice back or otherwise have the ability to terminate the agreement.

A good DMSC should provide a wide range of services: billing and collecting, scheduling and record management, negotiating with insurers, recruiting staff, leasing a practice facility, purchasing equipment, etc. Realize, however, that most DMSCs participate in managed care; it's either in their contract or part of their future planning. And, as far as marketing for new patients is concerned, the enticements of reduced fees or other "freebies" may not elicit the kind of quality patients that you want to attract.

In short, *read the fine print*. Pay attention to what's there, as well as to what's not there. DMSC successes to date have been primarily with orthodontic offices, due to the similarities from office to office. It is more difficult for a DMSC to be successful with GPs, due to the fact that offices can be quite diverse in the services offered to patients, along with the systems that support these services.

If you decide that such a venture is right for you, be sure that you want to work as an employee, and that you completely understand your absolute, downside risk. As one DMSC executive said to us, "Dentists are a lot different than physicians. They are harder to control and motivate."

"Of course," we replied, "dentists are hard-driving entrepreneurs who are used to achieving their wins independently. Welcome to the world of dentistry."

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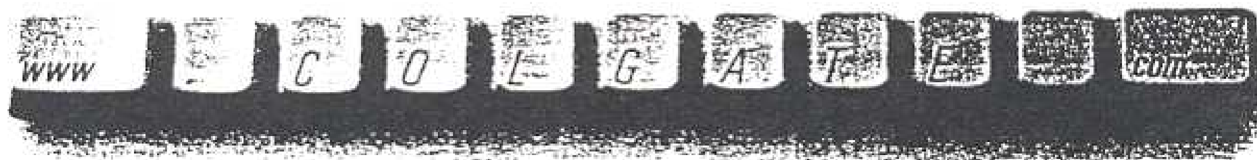

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