REPRESENTING THE PROFESSIONAL SELLING OR PURCHASING A MINORITY INTEREST IN A CORPORATE PRACTICE

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Dental, dental specialty, and veterinary corporate practices have substantially more saleable goodwill than other professional practices. As a result, dental, dental specialty, and veterinary practices are very valuable not only to incoming professionals, but to corporate practices attempting to enter the market. Corporate practices appear to be attempting to enter dental, dental specialty, and veterinary markets due to the return of patients or clients and substantial saleable value in the future. Corporate practices in dentistry began approximately in 1996.[1] In approximately 2002, the corporate practices began to disappear. Today, they're back and, for incoming professionals, practice ownership is less important today than it was in the past. In addition, dental, dental specialty, and veterinary practice owners do not seem as independent as they used to be when the professionals did not like working for someone else.

SELLING A DENTAL, DENTAL SPECIALTY, OR VETERINARY PRACTICE — VALUATION METHODS

There are three valuation methods for dental, dental specialty, and veterinary practices: (i) asset-based; (ii) market-based; and (iii) income-based.

Asset-based valuations

Asset-based valuations involve the valuation of all tangible and intangible assets individually. Ultimately, an asset-based valuation is the sum of the values of the individual assets. In dental and dental specialty practices, tangible assets consist of dental supplies, dental instruments, dental equipment, office equipment, furniture, and technology. Some practices, particularly ones that work with insurers, may also have accounts receivable. The most important asset, however, is intangible—goodwill, which represents approximately 75 to 85 percent of the value of the practice.[2] Goodwill generally reflects the quality and loyalty of the patient or client base and the likelihood that patronage will continue in the future. Veterinary practice asset-based valuations involve supplies, similar tangible assets, and goodwill, which is slightly less involved than in dental practices.

Market-based valuations

Market-based values are based on multiples of gross revenue and comparable practices. Although some broad comparability is applicable, individual practices vary in shape and size in ways that a multiple may not necessarily reflect. The multiple may fluctuate within a range based on a variety of factors that are given weight. Applying the multiple to gross revenues produces the market-based value. In its simplicity, this multiple of gross revenue method outshines the other methods and has become popular as a rule of thumb.

Market-based valuations, while not appearing to be truly accurate, reflect the market in a specific geographic area. For example, destination locations have relatively high values and, surprisingly, rural locations do not, because the non-doctor spouse often does not have a profession or occupation that lends itself to a rural setting.

Example: Market-Based Valuation

	Low	High
Gross collections	$1,000,000	$1,000,000
Multiplier	65%	80%
Market-based value	**$650,000**	**$800,000**

Income-based valuations

Income-based valuations primarily are capitalization of earnings in some form. With capitalization of earnings, doctor compensation in all forms is determined and the estimated remaining profit on a yearly basis is used to pay for the practice within a measured period. The longer the repayment period, the higher the value. In dental and dental specialty practices, the repayment period should be no more than seven years.[3]

Earnings before interest, taxes, depreciation, amortization (EBITDA)

While it may appear that the starting point in an income-based valuation is gross revenues, the critical element is profitability. A healthy profit margin is a major assumption in the use of the income-based method. The profit margin is based on the average of the most recent prior years and possibly the current year interim period.

Historically, net income has been the simple, customary measure of profitability in the dental, dental specialty, and veterinary sectors. With the advent of corporate practices in this space, however, the measure has shifted to EBITDA to reflect the profit available at the end of the day. Granted, that profit is calculated net of the owner's reasonable compensation.

Capitalization of earnings

The capitalization of earnings method extrapolates the value of a practice based on a capitalization rate, which is a major assumption when using

this method. The capitalization rate represents the buyer's, or, in the shoes of a corporate practice, the investor's expectation of the profitability of the practice and prompt recovery of the invested capital. If the capitalization rate were heads, a multiple would be tails. Dividing 100 percent by the capitalization rate results in the corresponding multiple. Corporate purchasers tend to anticipate higher multiples than their traditional counterparts—practicing professionals.

Example: income-based valuation — capitalization of earnings

	Low	High
Gross revenues	$1,000,000	$1,000,000
Expenses (include owners' comp)	($750,000)	($750,000)
Net profit (25% profit margin)	$250,000	$250,000
Capitalization rate	30%	20%
Income-based value	**$833,333**	**$1,250,000**

Discount of cash flows

As its name suggests, this method focuses on cash flows—the cash to be received from the income stream. The discounted cash flows method requires use of a reasonable growth rate that is assumed to remain constant over the repayment period. Other assumptions involved are the buyer's cost of capital, the buyer's risk premium for engaging in the acquisition and an appropriate discount rate for converted future cash flows into net present value.

Here, net income or EBITDA is projected over a repayment period. In the following example, the repayment term is estimated conservatively as 10 years—the standard term of a commercial loan extended to a professional purchasing a practice. This standard term is on the outer edge of the typical range anticipated by corporate buyers.

Example: income-based valuation — discounted cash flows

	Low	High
Gross revenues	$1,000,000	$1,000,000
Expenses (include owners' comp)	($750,000)	($750,000)
Net profit (25% profit margin)	$250,000	$250,000
Capitalization rate	31%	23%
Income-based value (NPV)	**$812,878**	**$948,501**
Growth rate	2% annually over 10 years	

Selling a dental, dental specialty, or veterinary practice to a corporate buyer

The benefit of selling a professional practice to a corporate buyer is that the selling price should be higher than what a private purchaser will pay due to the willingness of the corporate practice and ability to repay the purchase price over longer periods of time. The selling professionals should always receive a purchase price in cash at closing equal to or greater than what a traditional purchaser would pay. Historically, in veterinary practices, and more and more in dental and dental specialty practices, very profitable and desirable practices have been sold for cash at closing without any holdback amounts.

There are risks to the selling professional in selling to a corporate buyer. The first is that the selling professional will want to be held harmless from any state dental, dental specialty, or veterinary state board issues. Next, there are typically holdbacks based upon future performance of the practice and/or the professional that the professional is usually unable to control. In addition, there is typically a requirement of continued employment of the selling professional. The term of the required continuation of employment and compensation should be negotiated prior to closing. Notwithstanding the requirement of continued employment, a corporate practice may terminate the employment of a former

owner who wants to work on a part-time basis at some point after closing.

The selling professional should not forget to negotiate staff pay and benefit levels. These are sometimes substantially reduced by the corporate buyer, thereby potentially driving away valuable staff members, which can in turn lower practice revenue. The selling professional should certainly want the ability to leave the corporate buyer's practice under life-changing circumstances that are delineated in the purchase and sale agreements, as well as change of management or ownership of the corporate buyer. Failure to pay the selling professional or staff properly, including bonuses, or failure to pay holdbacks should also allow the selling professional to terminate employment with the corporate buyer and immediately receive all the unpaid holdbacks. The selling professional should have a security interest in the practice assets, including goodwill should a default occur, and the selling professional would also want the ability to obtain a lease assignment or retain the premises if the real estate is owned by the selling professional. Another factor arises when the corporate buyer fails to hire or locate an associate/successor for the selling professional at the time agreed upon under the purchase and sale agreements. Under certain triggering events, the selling professional would desire the ability to terminate his or her employment with the corporate buyer and have the restrictive covenants become null and void.

The restrictive covenants should certainly become null and void if the corporate buyer goes out of business. The term of employment should also include termination by the selling professional "for cause" and for "no cause." Liquidated damages for early termination should be specifically delineated in the post-sale employment agreement for the selling professional and compensation for services should be provided after the termination notice. Restrictive covenants should be reasonable under the applicable state laws. Restrictive covenants may allow for certain exceptions and permitted services. If the selling professional owns the real estate, the selling professional would desire a long-term lease with the ability to later sell the real estate either to the corporate buyer or a third party.

Consider a "clawback" provision

Including a clawback provision in the purchase agreement would be wise, particularly in a traditional purchaser context where arbitrage opportunities exist. This provision protects the selling professional from losing out on the opportunity to maximize the purchase price. Because a sale to a professional typically results in a lower purchase price, a purchasing professional could simply turn around and resell to a corporate practice, indirectly cashing in on the difference in price. A well-drafted clawback provision should set out parameters that require a purchasing professional to share in the windfall of excess proceeds in the event the professional sells to a corporate practice down the road.

Resale/succession agreement

A post-sale arrangement would be incomplete without a succession agreement in place. Typically, the selling professional would become an employee of the management company at the corporate practice. If this employment terminates for whatever reason, a succession agreement would allow for a smooth transition and would reduce the likelihood that the practice runs afoul of state board rules for corporate practice ownership. A succession agreement sets forth the details of transfer of the interests of the selling professional to a successor doctor. Death, disability, and incapacity are common baseline triggering events, in addition to termination for cause and for no cause.

Tips and thoughts

Always negotiate to ensure that the professional is held harmless from any dental, dental specialty, or veterinary state board issues regarding corporate practice ownership. Attempt to have the selling professional fully paid at closing or at least receive more than fair market value at closing than a private buyer would provide. Have a security interest for holdbacks to get the practice back. The selling professional should retain the ability to leave

if delineated triggering events occur. The selling professional should always maintain the ability to practice elsewhere should the relationship with the corporate buyer not work out through termination of the restrictive covenants. Finally, if the selling professional owns the practice real estate, there should be a long-term lease in place with the ability to sell the real estate at a specified time in the future.

JOINING A CORPORATE OR A LARGE DENTIST-OWNED PRACTICE AS A MINORITY OWNER

Corporate practice

The incoming professional should be aware of onerous restrictive covenants, especially for specialty practitioners. The incoming professional should retain the ability to leave because of poor management, deficient patient care, and change of ownership. The incoming professional should always negotiate a provision that any investment should be returned in full upon departure, unless the incoming professional's employment is terminated for cause as delineated in the shareholder/member employment agreement. Often, corporate practices (or the shareholder/member who earlier sold the professional practice of the specified location) retain the option, rather than the obligation, to purchase the interest of a departing minority shareholder or member, putting the departing owner at risk of only being able to sell his or her interest to another professional in the same corporate group or receive less than full value, if any. And yes, negotiate that the minority shareholder or member is held harmless from any dental, dental specialty, or veterinary state board issues.

Large dentist-owned practices

For large dentist-owned practices, the incoming professional should desire "meaningful ownership" primarily as to compensation and a return on investment. The minority shareholder or member should negotiate management responsibilities at the practice location where he or she primarily works. Performance should be based upon performance at the primary location. However, the minority shareholder or member would be responsible for coverage at other locations. The incoming professional should request the ability to purchase the primary location in the future based upon a formula, with the date and option pre-determined. The option to purchase the primary location should include the ability to lease or purchase the practice premises. The incoming professional should also desire to share in any windfall/sale to a corporate buyer by the majority owner, which should be delineated in the buy-sell agreement. The majority owner, on the other hand, should always retain the ability to sell the entire practice, all locations, to a corporate buyer or any other buyer.

Other minority ownership protections

Substantial majority owners typically manage and direct the operations of these medical and dental practices. Minority owners should be cognizant of and vigilant against oppressive and unscrupulous activity of the majority owners, including "freeze outs" or "squeeze outs."[4]

"Freezing out" a minority owner, includes preventing access to information, dilution of ownership percentage interest, forcing a low buyout price, discontinuing distributions or participation in any management decisions. "Squeezing out" a minority owner can include extreme actions such as forcing out a minority owner by merger.

In *Baker v. Wilmer Cutler Pickering Hale and Dorr,*[5] the LLC Operating Agreement provided substantial rights in managing the LLC to both majority and minority members. All members had exclusive discretion in the management and control of the business. The company could not amend the Operating Agreement without the unanimous written consent of all the members. The company could not amend the Agreement to alter the percentage interest of any member without the written consent of each member personally affected by such an amendment. Each member had a right to examine the company books and records at reasonable times. After payment of the initial capital contribution, a member could not be required to make any further capital contributions or loans to the company.

If a member advanced funds to the company, such advancement was to be treated as a loan. Finally, the Operating Agreement stated that each member owed a duty of utmost loyalty and good faith in the conduct of company affairs.

The LLC faced a financial shortfall. The majority owners wanted more equity in exchange for contributing additional funds to the company. One of the minority owners believed that the best path forward was to hire new management and develop a business plan. This minority owner agreed to dilute his interest, but only if outside investors provided capital and new management to the company. One of the minority owners rejected an offer from the majority owner to purchase that minority owner's membership interest.

The majority owners then hired counsel to assist in structuring a secret merger transaction (the Operating Agreement was silent about mergers) to bypass the provisions of the Operating Agreement. The majority owners relied upon a Massachusetts statute authorizing a merger upon a vote of members owning more than 50 percent of the company. The majority owners then converted loans into preferred stock while converting all existing membership interests into common stock. This effectively diluted shares of the minority owners. The new Operating Agreement did not provide any management rights to the minority owners.

The court noted that counsel for a closely held entity, as well as majority owners, can owe a fiduciary duty to the individual shareholders, depending on the specific circumstances. The court further held that the original Operating Agreement mandated a fiduciary duty of utmost good faith and loyalty. This is separate from the issue of creating an attorney-client relationship with an individual owner.

The court also noted that the Operating Agreement provided strong protections for minority owners. The majority owners' counsel should have communicated and consulted with the minority owners about the proposed merger. The minority owners should have been able to trust that counsel would protect their interests because of the protective language in the Operating Agreement.

Purchasers of a minority interest in an entity should review the internal corporate documents, including an Operating Agreement, to ensure that they receive adequate protection from overzealous and bullying majority owners. Should counsel for the entity advise only the majority owners or push an agenda that seems to benefit only such persons, a minority owner may claim that counsel has a conflict: Counsel has a duty to the entity itself, which includes a duty to protect all owners of that entity.

Non-compete clauses

Purchasers of a minority interest should consider asking for a non-compete clause for all owners of the entity. A "competing business" generally either refers to a business that is similar or related to the business of the company or refers to the rendering of services that are the same or substantially the same as the services, if any, rendered by a business owner on behalf of the entity.

This may present a tense, if not contentious, situation between the existing owners and an incoming minority owner. If any of the existing business owners are also full-time employees of the entity, such persons may not agree to a non-compete clause. Minority business owners often provide "sweat equity" to the entity. Other owners may develop expertise and valuable experience from owning or associating with the entity. The minority owner may want to limit the ability of other owners to use all these resources to compete against the entity, either during one's term of ownership interest or after disposition of same.

Without such non-compete clauses, the minority owner's interest is exposed to a reduction in value due to potential disclosure of trade secrets or confidential information to the former co-owner's new company. In some cases, the offending owner may extort overpayment by the entity to buy out that owner's interest, thus exposing the entity to reduced income and value. The minority owner may want to request provisions regarding non-solicitation,

non-disclosure, confidentiality with entity trade secrets, and other related provisions to be included in the internal entity documents.

No matter what, the incoming dentist should always retain the ability to leave and have his or her investment returned. Restrictive covenants should not be overly restrictive. In a large dentist-owned practice, if the practice does not want to retain the new owner, there should be an increase in the buy-out price, depending upon the terms of the shareholder/member employment agreement. For minority owners, the majority owner would want an incremental buy-in to correspond with S corporation distributions. One way to distinguish a corporate practice from a large dentist-owned practice is by capital from outside sources.

CONCLUSION

Like it or not, it looks like corporate practices are here to stay. Clients should be advised not only of the possible benefits of selling to or becoming a minority owner of a corporate or large dentist-owned practice, but also the risks.

Notes

1 William P. Prescott and James R. Pride, Who's the Boss? Dental Economics, PennWell Corporation, Mar. 1998.

2 William P. Prescott, The current status of personal goodwill, Dental Economics, Oct. 2016.

3 Joining and Leaving the Dental Practice (4th ed., to be published by the American Dental Association), available at https://www.ada.org/resources/careers/joining-and-leaving-the-dental-practice.

4 See, e.g., Baker v. Wilmer Cutler Pickering Hale and Dorr, LLP, 81 N.E. 3d 782 (Mass App. Ct. 2017).

5 Id.