

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 acquisition. 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 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.

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 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 revenues 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 gross revenues and profitability in some way over the long term.

¹ Henry Campbell Black, M.A., Black's Law Dictionary, West Publishing Company, St. Paul, MN, 1979, 5th ed., p. 411.

As part of this process, it is essential for your accountant to prepare a budget of your anticipated practice revenues 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.

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.

The proposed structure and terms of the acquisition would then be included in the second category of the due diligence process.

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).

Figure 7-1

DUE DILIGENCE CHECKLIST²

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

Completed Not Completed Inapplicable

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

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|-------|-------|-------|--|
| _____ | _____ | _____ | *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; |

² William P. Prescott, M.B.A., J.D., The Practice Acquisition Handbook, Randall K. Berning and Affiliates, Naples, Florida, 1997, Appendix I.

Figure 7-1

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|-------|-------|-------|-----|--|
| _____ | _____ | _____ | *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. |

Figure 7-1

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.

Figure 7-1

D. Lease and Real Estate Matters

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

Figure 7-1

E. Operational Matters

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|-------|-------|-------|-----|---|
| _____ | _____ | _____ | *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); |
| _____ | _____ | _____ | *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); |

Figure 7-1

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|-------|-------|-------|--|
| _____ | _____ | _____ | 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; |

Figure 7-1

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|-------|-------|-------|-----|--|
| _____ | _____ | _____ | 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 |
| _____ | _____ | _____ | 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

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|-------|-------|-------|-----|--|
| _____ | _____ | _____ | *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; |

Figure 7-1

_____	_____	_____
_____	_____	_____
_____	_____	_____

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.

Figure 7-1

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.