

Chapter 20

ACQUIRING YOUR PRACTICE — THE IMPORTANCE OF PURCHASER DUE DILIGENCE¹

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."²

The purpose of the due diligence or purchase investigation is to determine whether the acquisition should be made³ 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).⁴

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: (i) comparison of your practice options; (ii) preparation or confirmation of the proposed practice valuation, structure and terms of the acquisition; and (iii) 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: (i) the available opportunities within the specified geographical area(s) where you intend to practice; and (ii) 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

¹ William P. Prescott, M.B.A., J.D., *The Practice Acquisition Handbook*, Randall K. Berning and Affiliates, Naples, Florida, 1997, pages 12-16, Appendix I.

² Henry Campbell Black, M.A., *Black's Law Dictionary*, West Publishing Company, St. Paul, MN, 1979, 5th ed., p. 411.

³ Gere D. McGaffey, *Buying, Selling and Merging Businesses*, Second ed., Ali-Aba, Philadelphia, 1989, p. 16.

⁴ *Buying and Selling Closely Held Businesses in Ohio*, PES, Inc., 1989, p. 5.

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.

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: (i) earn a reasonable living; (ii) pay the operating expenses which you will incur in the practice; (iii) pay the lender(s) the purchase price for the practice; and (iv) 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 20-1 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 20-1 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 20-1 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: (i) those economic in nature; and (ii) 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 20-1: (i) Compatibility of Purchaser and Seller; (ii) Financial Information; (iii) Practice Facility; (iv) Lease and Real Estate Matters; (v) Operational Matters; (vi) Employment Relations and Benefits; (vii) Litigation, Pending/Threatened; and (viii) 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: (i) future renovations; (ii) a possible relocation; (iii) an expansion; or (iv) 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: (i) obtain a lease, or lease assignment, for the premises of the practice; (ii) purchase the premises, land and building/condominium; or (iii) 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.

Operational Matters

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).