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Buyers & Sellers:
A Guide to Practice Transition

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Presentation Bio for Thomas F. Ziegler, DDS, MS, JD
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Tom Ziegler practiced orthodontics for 30 years and has been an attorney for the past 22 years. In 1995, he founded Ziegler Practice Transitions, Ltd. (ZPT), an orthodontic practice transition consulting firm, which performs orthodontic practice valuations, as well as negotiates and drafts Purchase & Sale Agreements and various other transition documents for Buyers and Sellers in all 50 states. ZPT is unique in that they specializing in working with both the Buyer and Seller together to design fair and neutral transition plans, with each party sharing the tax benefits and burdens.

ZPT has been involved in over 1,800 orthodontic practice transitions over the past 22 years. Tom was the practice transition speaker for the Bottom Line University Program, sponsored by 3M Unitek and presented to all orthodontic residents from 1997-2012. Since 2015, ZPT has been an AAO Annual Session sponsor and this is the 5th time Tom has been an AAO practice transition panelist (2001, 2007, 2008, 2012 and 2017).

Degrees & Accolades:

- Miami University – BA Zoology
- The Ohio State University College of Dentistry – DDS, cum laude
- The Ohio State University College of Dentistry – MS, orthodontics
- Salmon P. Chase College of Law at Northern Kentucky University – JD
- Diplomate of the American Board of Orthodontics
- AAOF Corporate Regent Partner
Buyers & Sellers: A Guide to Practice Transition

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DISCLAIMER:

"I, the undersigned, declare that neither I, nor any member of my family, have a financial arrangement or affiliation with any corporate organization offering financial support or grant monies for this continuing education presentation, nor do I have a financial interest in any commercial product(s) or services I will discuss in this presentation."

– Thomas F. Ziegler, DDS, MS, JD

Initial Planning:

Know What You Want
**Seller’s Fantasy**

“I’ll hire an Associate... to grow my practice so I can make more money”

**Reality**

Year 1, the Associate will reduce your income by what you pay the Associate in compensation + benefits, plus additional staff and payroll costs.

**Seller’s Fantasy**

“I’ll hire an Associate... to grow my practice so I can make more money”

**Reality**

The Associate will not generate new business sufficient to offset new costs, unless you already had a backlog of patients waiting to start treatment.

**Seller’s Fantasy**

“I’ll hire an Associate... to grow my practice so I can make more money”

**Reality**

It will like take more than two years for the Associate to start generating increased income sufficient to cover his/her own added cost.
Seller’s Fantasy
“I’ll hire an Associate... so I can sell at a higher price”

Reality
To not disincentivize the Buyer from working hard to grow the Practice, the Buy-in Price will be set before the Associate starts working

Seller’s Fantasy
“...wait...WHY AM I HIRING AN ASSOCIATE?”

Reality
The purpose of hiring an Associate is not to grow your practice, it is to secure a Buyer (near term 100% sale) or, alternatively, to begin to grow the practice in preparation of a 5-year Buy-in

The Associate
Associate Salary, Benefits & Increased Staff Cost: $200k+/year

It will take 2-3 years before Associate starts bringing in money to break even on cost
The Associate

A 2-year Associateship and 5-year Buy-in to 50% ownership should result in growth sufficient to increase net income to cover amount lost to Partner

Practice size should double in 7 years

Said another way, the Seller’s net income remains fairly stable as he/she sells off 50% ownership

The Associate

Seller takes a hit in the beginning to:

1. Secure Buyer and lock-in a legally binding transition plan; and
2. Allow for sufficient time to grow the practice and help negate the effect of adding a Partner

Seller’s Decisions

Seller must decide what to do:

1. Associate with no guaranteed sale;
2. Associate for 1-1.5 years, leading to 5-year Partnership buy-in to 50% ownership; or
3. 100% Sale up front and work-back as needed for up to 6 months
There are +/- to each option... with extended time (i.e. long Associateships/Partnerships) comes the increased need for the parties to be compatible with one another.

Initial Planning:
Know What Buyers Want

Buyer’s Want
1. A job – Associate Agreement only;
2. An Associateship for 1-1.5 years then start buying-in over time to 50% Partnership and 100% at some point in the future; or
3. Buy 100% upfront and hire Seller back for up to 6 months after Closing, as needed
**Buyer’s Fantasy**

“I’ll will add hundreds of thousands of dollars worth of new business because I’m young and eager”

**Reality**

It is similar to a start-up...
In year 1, you’re lucky to even cover your bills and you’re not really making any money until year 3 or 4 with the practice to full maturity by year 7.

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**Buyer’s Decisions**

Why only be an Associate?

When starting a practice nearby (outside of Restricted Area) and need to supplement income

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**Seller’s Decisions**

Why hire an Associate with no sale?

1. Reduce time in the office
2. Make a satellite office more productive (demand must already exist, just lacking time to devote)
3. No plans to retire for at least 7 years
Partnership Worthy
Know Thyself (both Buyer and Seller)

1. Are you willing to routinely put in more time than the other doctor?
2. Are you willing to let small discrepancies slide to keep the peace?
3. Are you willing to sacrifice for the other doctor?
4. Are you able to openly communicate, listen well and give up some of your wants to compromise?

If EITHER of you cannot answer yes to all of those questions, you cannot have a Partnership.

Alternate Plans:
Seller – wait until you’re ready to sell
Buyer – find another opportunity or start your own

Staff & Transition
When and What to Tell Them

- Staff Concerns
  - Worried about their Job Security
  - Who will retire with Senior Doctor
  - What does Junior inherit?
  - Fire & Retire Provisions
Practice Appraisal

Why an Appraisal is Needed **UPFRONT**
- To determine if the cash flow is large enough to support an Associate
- To establish the price of the buy-in (Partnership Path)
- To determine if any changes are needed prior to sale (100% Sale)

Practice Appraisal
(Bank Requirements)
- Demographics of location(s)
- Number of years in current location
- **Lease** – termination and extension
- Real Estate Owned – **Option to Purchase**
**Bank Requirements**  
*(from the Seller)*

- Practice Tax Returns *(Past 3 Years)*
- P&L Statements *(Past 3 Years & YTD)*
- Active patients *(Phase I, Phase II & Comprehensive)*
- Average starts per month
- Number of patients in recall file
- Total Contract (Account) Balances =  
  - Accounts Receivable + Contracts Receivable

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**Practice Appraisal**  
*(Factors Considered by Appraiser)*

- External Marketing
- Internal Marketing
- Staff Census
- Staff Salaries *(percentage of gross)*
- Photographs of the office  
  - Inside *(from the front door to the back door)*
  - Outside *(parking lot & signage)*

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**Practice Appraisal**  
*(Factors Considered by an Appraiser)*

- **Inventories**: *(approx. orig. cost & purchase date)*  
  - Dental Equipment
  - Office Furniture & Equipment
  - Dental Supplies & Instruments
  - Office Supplies
Contracts Receivable (C/R)

Monies to be billed in the future, for work to be done in the future, in order to complete treatment on all current, active patients

UNIQUE TO ORTHODONTICS

Orthodontic Billing

- Typically, in orthodontic practices, the fee for service is prorated over the treatment time
  - 25-30% initially
  - Balance paid equally over 18-24 months

Orthodontic Billing

How to handle extra fees for:
Invisalign
AcceleDent &
SureSmile
Orthodontic Billing

Cases with large lab fees should have those extra fees paid by the Patient upfront in addition to your usual fee

When this usual method of 25% down and balance over 24 months, a large amount of future payments are due Buyer

These future payments due are the Contracts Receivable

It is important to know what the normal relationship is between the value of an orthodontic practice and the Contracts Receivable

\[
\text{Gross} \approx \frac{C/R}{0.7} \text{ (25% & 24 Months)}
\]

\[
\text{Gross} \approx \frac{C/R}{0.56} \text{ (30% & 18 Months)}
\]
Any approximation of FMV based on Gross, Net or C/R will be subject to adjustment, up or down, by other factors.

Adjustment to Sales Price Before Closing
- DOWN
  - Material deterioration of financials
  - More than 10% decline in Gross, Net and/or CR
- UP
  - Added Equity Value of Assets greater than $10k individually

Adjustment to Sales Price Before Closing
- Paid in Full Patients with Treatment Remaining
  - Estimate months left x typical monthly payment, credit to Buyer via reduction in sales price
  - Estimate a down payment of 25%, with the balance billed over 24 months; Seller is entitled to down payment + monthly payments between start of treatment and closing
Adjustment to Sales Price Before Closing

- Patients with large lab bills (Invisalign)
  - Deduct lab bill first, then calculate remainder at 25% down and balance over 24 months

Appraisal


Bud Schulman:
Seller financed sale with purchase price and Interest paid by Buyer should approximate the Buyer and Seller splitting the net 50/50 for 60 Months

Cash Flow (Anytime)

If the valuation is correct, the Buyer should be able to pay for the Debt Service (Principal + Interest) and still have ample money to live on
Methods of Approximating Fair Market Value

- Percentage of Gross (50% to 100%)
- Adjusted Net Income (Salary + Perks) multiplied by a factor (1 to 2)
- 1.5x Adjusted Net Income plus the current value of the Tangible Assets
- Contracts Receivable \div a factor (0.56-0.7)

Tax Allocation of the Purchase Price

Sellers Prefer:

Capital Gains (Goodwill or Stock) vs. Ordinary Income Tax (Assets)
Buyers Prefer:

Deductible as Paid (Pre-Tax)
(Assets or Management Fees)

or

Deductible Over Time
(Goodwill)

vs.

Not Deductible
(Stock)

What is the Reasonable Solution?

That depends on whether it is a 100% Sale or a Fractional Sale
Types of Practice Sales

Asset Sale (100% Sale)
- Corporate Assets (10%)
  - Buyer → deductible over 5-7 Years
  - Seller → ordinary income tax on amount above Depreciated Book Value
- Personal Goodwill (85%)
  - Buyer → amortize over 15 Years (Finance over 10 Years)
  - Seller → Capital Gains
- Covenant Not to Compete (5%)
  - Buyer → amortize over 15 Years (Finance over 10 Years)
  - Seller → ordinary income tax

Stock Sale (Buy-in is Seller financed)
- Stock (10%)
  - Buyer → Non-deductible (100% after tax $$$)
  - Seller → Capital Gain (20% tax)
- Management Services (90%)
  - Buyer → Deductible as Paid (payments are pre-tax)
  - Seller → Ordinary Income* (40% tax)

Note: Seller was already paying ordinary income tax on this money, which he was already receiving anyway (minimal inconvenience to Seller)

Unlike 100% Asset Sales, Fractional Sales must be in two steps because of tax law implications

Step 1: Buy-in
Step 2: Buy-out
Example of the Process for a 50% Buy-in
(Designed to Benefit Buyer)

- Assume that the total practice value, per Appraisal, was $1.2mil
- Therefore, the value for 50% would be $600k
  - $60k for Stock
  - $540k for the Management Services of the Selling Doctor

\[ \text{Value for 50%} = \frac{$600k}{2} = $300k \]

Example of the Process for a 50% Buy-in
(Stock Purchase)

- $60k ÷ 5 years = $12k per year
to be paid by Buyer, personally, to Seller, personally,
each January 1st for 5 years

\[ \text{Annual Payment} = \frac{$60k}{5} = $12k \]

Example of the Process for a 50% Buy-in
(Income Shift for Management Fees)

- $540k ÷ 60 Months = $9,000
to be shifted each month (for 60 Months)
from Junior’s share of Net Income, to Senior’s share of Net Income,
before W2 income is tabulated

\[ \text{Monthly Shift} = \frac{$540k}{60} = $9,000 \]
The Buy-in Rationale

- The Buyer has no money
- The Seller has plenty
- Therefore, the advantage at this stage should go to the Buyer

Process for the Buy-out of 2\textsuperscript{nd} 50% (Designed to Benefit Seller)

- The Buy-out
  - In the event of:
    - Disability,
    - Death, or
    - Retirement of the Senior Doctor

Process for the Buy-out of 2\textsuperscript{nd} 50% (Designed to Benefit Seller)

- Practice re-appraised at that time
  - Stock (10%)
    - Buyer → non-deductible (100% After Tax $$$)
    - Seller → Capital Gain (20% Tax)
  - Personal Goodwill of Seller (85%)
    - Buyer → amortized over 15 Years
    - Seller → Capital Gain (20% Tax)
  - Covenant Not to Compete (5%)
    - Buyer → amortized over 15 years
    - Seller → ordinary income
Third-Party Financing
(100% Purchase or Final Buy-out)

Buyer should finance the buy-out or 100% purchase over 10 years (at a fixed rate of interest) to mitigate the 15 year Amortization Schedule for Goodwill Payments.

The Buy-out Rationale

- The Buyer can get Bank financing
- The Buyer now has money
- The Seller is retiring
- Therefore, the advantage at this stage should go to the Seller

* This evens-up the Tax Advantages over the 2-step transition (Buy-in/Buy-out)

Compensation During the 50% Buy-in

- Gross Receipts less Refunds, less Overhead equals Net Income
- Separate Net Income into two (2) equal portions
- One (1) portion is shared between Buyer and Seller based on their relative Percentage of Days Worked
- The other portion is shared based on the following table:
Compensation During the 50% Buy-in

<table>
<thead>
<tr>
<th>Year</th>
<th>Buyer</th>
<th>Seller</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10%</td>
<td>90%</td>
</tr>
<tr>
<td>2</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>3</td>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>4</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>5</td>
<td>50%</td>
<td>50%</td>
</tr>
</tbody>
</table>

Cash Flow Approximation

(Buy-in with Zero Growth)

- Assume:
  - Gross Income = $1.5mil
  - Net Income = $750k
  - Purchase Price for 50% = $600k

Year 1 Earnings: (Assume Equal Days Worked)

<table>
<thead>
<tr>
<th>Portion 1 (days worked)</th>
<th>$375k</th>
<th>Portion 2 (refer to table)</th>
<th>$375k</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyer:</td>
<td>$187k</td>
<td>Seller:</td>
<td>$187k</td>
</tr>
<tr>
<td></td>
<td>$167k</td>
<td>10% = $38k</td>
<td>90%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>90% = $337k</td>
<td></td>
</tr>
</tbody>
</table>

Buyer: $187k + $38k = $225k
Seller: $187k + $337k = $524k
Cash Flow Approximation
(Buy-in with Zero Growth)

- Year 1 Payments:
  - **Stock** ($60k)
    - $12k per year for 5 years
  - **Management Fees** ($540k)
    - $108k per year for 5 years

  **Buyer:** $225k MINUS $120k = $105k (W2)
  **Seller:** $524k PLUS $120k = $644k (W2)

Rationale for Compensation Sharing

- 50% Based on Days Worked
  - Seller may want to take off more time
  - Prevents "Buyer Abuse" by Seller
- 50% Based on Table
  - Gradual percentage of ownership
  - Prevents Buyer from receiving too much, too early

Buy-out of the 2nd 50%

- Death, Disability or Retirement of the Seller Doctor
- Re-appraisal of the practice value at that time
- Value of the 2nd 50% allocated to:
  - Stock (10%)
  - Seller’s Personal Goodwill (85%)
  - Covenant Not to Compete (5%)
Buy-out of the 2nd 50%

- Seller:
  - Everything except the Covenant Not to Compete is taxed as a Capital Gain (20%) rather than ordinary income tax (40%)

- Buyer:
  - Stock:
    - Paid personally with after-tax dollars
  - Seller's Personal Goodwill
    - Amortized over 15 years
  - Covenant Not to Compete
    - Amortized over 15 years

This is used to unravel a Fractional Sale if it is terminated during the Buy-in years

Spells out:
- How much the Buyer would receive, and
- How it would be paid based on various situations causing termination during the Buy-in years
Supplemental Agreement
(Fractional Sale)

If Seller fires Buyer WITHOUT Cause:

- Selling doctor personally repays Buyer for the amount Buyer paid for Stock
  - (cash payment within 30 days)
- The corporation repays Buyer for any amount paid for Management Services through pre-tax Income Transfer
  - (paid as Deferred Compensation over the same time period as paid-in → Interest Free)

Supplemental Agreement
(Fractional Sale)

If Seller fires Buyer FOR CAUSE:

- Selling doctor repays Buyer 50% of the amount he paid for the Stock
  - (by Promissory Note at 6% interest over 36 months)
- The corporation repays Buyer 50% of the amount he paid in Management Services
  - (Deferred Compensation over the same time period as paid-in → Interest Free)

For Cause Means:

- Loss of Dental License
- Unable to obtain Malpractice Insurance
- Convicted of a felony
- Addiction to drugs or alcohol
- Acts of Moral Turpitude
- "Material Breach" of the Agreement after having been given Written Notice of the Breach and a reasonable opportunity to cure the Breach
Shareholder Agreement
(Buy-out Terms AFTER the Buy-in Years)

- New valuation required to sell
- Once there is more than one Shareholder, there needs to be a Shareholder Agreement to dictate how the practice will be operated and valued for purposes of a Buy-out
  - Specify how the practice was originally valued for the Buy-in
  - Then, use that same method later for the Buy-out

Types of Events Triggering a Buy-out

- Death
  - Buy-out obligation of surviving Shareholder
  - Cross-purchase term life insurance
  - non-taxable transfer
- Disability
  - Insurance cannot fund the Buy-out
  - Places burden on the other Shareholder
- Retirement
  - Either voluntary or involuntary termination of employment

Associate Agreement

- Terms:
  - State License
  - 1 to 2 years
  - Base Compensation:
    - 1st year \( \rightarrow \$10,000-$12,000/\text{month} \)
    - 2nd year \( \rightarrow \$15,000-$18,000/\text{month} \)
Associate Agreement

Benefits paid in addition to Salary
- Pension election
- Deduct from salary
- Malpractice insurance
- Reasonable dues
- AAO, ADA, state, local
- License fees
- Medical insurance premiums
- Reimbursement for entertaining referring dentists
  - Pre-approved by Employer

Items Paid by Practice for Employee
- Deducted from Gross salary before W-2
- Travel & Entertainment
- Continuing Education
- Business car expenses

Duties
- Exclusive employment
  - 5 days/week
  - 4 clinical
  - 1 administrative
- Staff Meetings
  - Treatment planning
  - Professional relations (marketing)
  - Administrative duties
**Associate Agreement**

- **Termination**
  - At Will (30 Day Notice)
  - For any reason at all
  - Severance of 30 Days Pay

  *With a signed Purchase & Sale Agreement, you’ll need FOR CAUSE reasons to terminate*

- **For Cause (No Notice)**
  - Death of Employee
  - Loss of Dental License
  - Disability exceeding 30 days
  - Addiction to drugs or alcohol
  - Fraud, dishonesty, Moral Turpitude
  - Failure to abide by written policies
  - Convicted of a Felony

**Restrictive Covenants**

- Covenant Not to Compete
  - 2 years / 10 miles (big city suburb)
  - Stipulated Damages
    - % of Gross collections for 2 years
  - Reasonable Time and Distance Restrictions
  - Protect Employer from Employee
    - Associate period
  - Protect Buyer from Seller (2nd type)
    - After closing on the sale
Associate Agreement

- Restrictive Covenants (components)
  - Covenant Not to Disclose
  - Covenant Not to Induce
  - Covenant Not to Divulge
  - Covenant Not to Solicit
  - Covenant Not to Compete

Real Estate

- Buyer MUST have a Lease in place at Closing
- If owned by Seller, an Option to Purchase the real estate at its Fair Market Value needs to be in place
  - once Seller has been paid in full
  - during the term of the Lease or extensions by written notice

Post-Closing Employment of the Seller

- Takes place after:
  - A 100% sale; or
  - The Buy-out of the 2nd 50%

- Seller will not make as much money as before the sale
- Buyer will have to pay Debt Service out of the practice Net Income AND still have enough to live on
Post-Closing Employment of the Seller

- Buyer’s pay will be reduced by the amount paid to Seller as compensation
- Rule of thumb for Seller’s Post-Closing compensation:
  - 10% of annual Gross, or
  - 0.001 x last 12 months’ Gross (per diem)
  - based on 100 days of work