

# Eleven Essential Steps to Purchasing or Selling a Medical Practice

These tasks will make for a smoother transition.

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The attorneys on the Medical Practice team of Mandelbaum Salsburg have represented more than 100 doctors and medical specialists in the sale and acquisition of practices. In our experience, the same issues occur in many deals. We have found that if the buyers and sellers take 11 key steps in buying or selling a practice, they are likely to have a successful transition.

## Consider a Letter of Intent

Rather than incurring the expense of negotiating and drafting a contractual agreement, consider entering into a letter of intent (LOI) with the other party. An LOI is a document that outlines the preliminary agreements and understandings between the parties to the transaction. It is not, nor should it be, a legally binding contract. It should simply describe the essential business terms of the deal, including timing, monetary terms, financing, deal contingencies, risk allocation, transition, form of documentation, and which party will prepare the documentation.

A well-drafted LOI eases the transition from a potential deal into a binding contract, in that the parties

have already agreed to all the essential terms of the deal. Because the parties have agreed in advance to certain key points, less is left open to negotiation, and the chances of the deal falling through are reduced. LOIs are nonbinding and should specifically state that “the terms contained herein are not binding on either party and are merely intended to be a conceptual understanding of key terms between the parties.”

enter into a written contract that provides for due diligence as part of the terms, with a closing to follow upon satisfaction after due diligence. The buyer should satisfy himself or herself during the due diligence period by conducting a physical inspection of the premises as well as a thorough review of the assets, books and records, tax returns, financial statements, patient charts, accounts receivable, personnel files, employment

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Because attorneys are routinely left out of the drafting process, legal fees and delays can be avoided. However, complex LOIs are sometimes drafted by attorneys, and consulting with your attorney during the process will ensure that you have considered all of the key provisions of the transaction. Attorneys can use the LOI as a basis to quickly and efficiently negotiate and draft the necessary documentation.

## Do Your Due Diligence

Parties generally proceed with their due diligence in one of two ways: 1) prepare a letter of intent with confidentiality requirements and a right to conduct due diligence prior to drafting the contract; or 2)

agreements, leases and contracts, list of creditors, insurance policies, and benefit plans.

You should also be sure to confirm with the municipality and verify if there are any local, city, or state approvals required to operate the practice. Involve your accountant and attorney during due diligence; both of them should have experience in dealing with doctors and the business of running a practice.

The buyer should run a search against the selling business entity and the principals of the entity to make sure there are no liens against the practice assets, such as judgments, tax liens, lawsuits, or UCC fi-

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nancing statements. Most importantly, during due diligence, the buyer will want to determine the viability of the real estate lease where applicable, ratify the fairness of the purchase price, verify financial data, be satisfied as to personnel and other key contracts, verify clear title to the assets, inspect charts and cross-reference them with billings and procedures, and determine insurance plan participation needs.

### **Negotiate the Lease**

A significant amount of goodwill attaches to the location of a medical practice. The buyer should not make the mistake of assuming that the terms of a lease are beneficial simply because the seller has been in the location for a long time. The buyer should request a copy of the lease immediately upon taking an interest in a practice and begin a dialogue

with the landlord early in the process. In anticipation of the sale, the seller should speak upfront with the landlord. It is usually advantageous for the buyer to be able to negotiate a new lease directly with the landlord. However, when the seller already has a favorable lease and a term with re-

on your lease, organize your extension rights and clean up your lease relationship before you list your practice.

### **Secure Financing**

In the world of business transactions, financing medical practice transitions is sometimes difficult at

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newal rights, you may also be able to negotiate a simple assignment.

In either case, the two parties will in most cases need the landlord's consent to the new tenancy. The buyer's lender will generally require a lease term and/or extension rights to cover the entire length of the loan. If you are a seller with a short term remaining

best. Financing requires a lien on the practice assets, so if the cash flow of the practice can service the debt, cover the practices expenses, and provide enough income for the buyer to pay his or her personal bills, in most cases the lender will agree to fund the deal.

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Typically, the rates are at market and comparable to other commercial loans, but the terms may vary based on the ability to service the debt, the debtor's credit score, and the size of the loan. Loan terms are commonly 5, 7, or 10 years, with equal monthly installments of principal and interest. Larger deals or multi-practice deals may have terms as long as 15 to 20 years. The lenders often have an impact on establishing the price for a practice during due diligence. Sellers who seek premium pricing are often asked to take back a note and finance amounts in excess of what a specialty lender will lend.

### **Zoning**

One of the first legal issues to consider when conducting due diligence on a practice location is whether or not there is a valid certificate of occupancy and if local building

and zoning ordinances permit the continued use as a medical practice. Each municipality has its own zoning rules and regulations. Do not assume that what works or is allowed in one place will work or be allowed in another. All municipalities have copies of their zoning code and zoning map available for purchase for a nominal charge. You will want to identify the particular "zone" where the practice is located and review the requirements and prohibitions that apply to that zone. Even if a particular use is permitted in the zone, there could be other issues that may affect your use (such as parking requirements) or that require a variance or need approval for your intended use.

A variance is an order from the municipality granting relief to a property owner from a particular ordinance or restriction. A person or business must apply to the municipality for such relief, which can be a time-consuming process.

Most people do not realize that in the purchase of a long-standing existing practice, variances may still be required for any number of reasons, such as a pre-existing nonconforming use that predates the zoning regulations. Such uses can trigger problems upon the transfer of ownership from the existing owner to the new owner.

Regardless of whether you need a variance or a use is readily permitted, many municipalities require certificates of occupancy and a planning board appearance before allowing a business to conduct its permitted use. These application and appearance requirements allow cities and towns to monitor the uses, occupants, and tenancies at any particular location in the municipality. It also gives the governing authority a chance to ask questions about the potential business, the hours of operation, use, number of employees, parking space requirements, and any other matters

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of concern to the municipality. This process can cause delay.

## How to Manage Accounts Receivable

There are a variety of ways to manage accounts receivable. The most common are:

- Seller keeps the receivables, and the buyer collects them as a courtesy or for a fee.
- Seller collects and keeps the receivables.
- Buyer pays additional consideration and collects the receivables post-closing.

Determine early on in the negotiation the total accounts receivable the seller has, including the aged accounts. The seller generally wants the buyer to collect the receivables and pay them over as collected, but the stumbling block is determining who gets paid first. It is recommended that the buyer either purchase the accounts receivable for a fair price based on dollar amount and historic collections performance, or collect the receivables for the seller as a courtesy or for a small administrative fee. The seller may collect the receivables, though the buyer could risk damage to the practice's goodwill if the seller adopts aggressive methods to chase patients for payment of old bills.

## Establish Clear Restrictive Covenants

Unlike an employment relationship where courts frown upon overly restricting a person's right to work, when you buy a practice, it is reasonable to require the seller to enter into a post-closing restrictive covenant with a substantial time and geography limitation. The seller is receiving significant consideration—the purchase price—and the buyer is acquiring all of the goodwill and, in most cases, taking on significant debt to buy the practice. So the seller should be prepared to remove himself or herself from the marketplace. A restrictive covenant of five years, and certainly no less than four, is recommended. Geographic limitations vary

depending on your location. In suburban and rural locations, the limitation is defined in terms of number of miles, whereas in urban settings, the limitation may be expressed in terms of city blocks or neighborhoods.

## Determine an Appropriate Transition Period

It will benefit the buyer, seller, and patients to have a reasonable transition period; and the arrangement should be agreed upon early and included in the contract. While it is possible in theory to have an effective transition that takes place in as few as 90 days, six months to a year is a more reasonable length of time as the buyer will have the opportunity to work with the seller's patient base for an entire treatment cycle (in the case of annual visits or physicals). At a minimum, the seller should be willing to answer questions and make introductions to patients, staff, and referral sources as a courtesy or for a very nominal consideration. If the seller is going to continue to treat patients, however, he or she will essentially be an employee and should be paid a percentage of collections on a reasonable per diem salary. The buyer should reserve the right to terminate the seller if the post-closing chemistry is not working, though this should not be undertaken lightly.

The reality is that sellers generally have worked their entire career in the practice, are accustomed to being accountable to no one, and are sensitive to being treated as an employee. They may have difficulty taking direction, and the buyer may expect a level of respect and deference. The buyer cannot afford to have his or her credibility undermined by the seller.

## Determine Purchase Price Allocation

The purchase price that is allocated in a practice transition can have significant tax implications for both parties. Typically, in an asset purchase, sellers want to allocate as much of the purchase price as possible toward goodwill. Those allocations receive capital gains treatment, which is a significantly lower tax rate

than ordinary taxable income.

Conversely, if allocation is applied toward furniture, fixtures, and equipment (FF&E), to the extent the seller has already depreciated such FF&E, he or she will have to recapture the prior depreciation, which is subject to ordinary income tax treatment at a higher tax rate. Buyers prefer FF&E treatment because they will depreciate the FF&E on an expedited basis and get a faster tax benefit, as opposed to goodwill, which is depreciated over 15 years.

## Determine Assignable Contracts

During the due diligence process, it is vital that the two parties identify essential contracts in the operation of the practice and decide whether or not such contracts will be assumed by the purchaser. Such contracts may include real estate leases, medical practice equipment leases, office product equipment leases, software licenses, maintenance agreements, management agreements, marketing and advertising agreements, personnel contracts, and any other contracts for which there are long-term commitments. Such agreements may require prior written consent from the lessor and credit approval for permitting assignment, which may impact the amount of lead time necessary for closing.

## Draw Up the List of Assets

Attach an asset list to the purchase agreement detailing all items being purchased as part of the transaction. Alternatively, it may be easier to create a video of assets and attach a disk rather than a list. Equally important, identify those items that are not included in the closing. Typically, this includes cash on hand, accounts receivable, personal property of the seller, artwork, and personal computers. **PM**



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