Buy/sell agreements: Getting into and out of a partnership without hard feelings

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Abstract

It's easy to delay planning for the eventual sale of your hospital given the typical to-do list of veterinary practice owners. But, all empathy aside, a transition plan is essential for the continued existence of the practice and your family's future financial security. No crystal ball exists to tell you exactly what the future holds. Life happens! But with a little preparation – okay, a lot of preparation – your odds for success are much greater. This presentation is intended to provide insight on the complexity of buying or selling a practice, and examples of areas that should be considered during buy-sell negotiations.

Key words: practice management, buy/sell

Résumé

Il est facile de remettre à plus tard la planification de la vente éventuelle de votre hôpital en raison de la liste typique des choses à faire du propriétaire d'un pratique vétérinaire. Mettant de côté toute compassion, un plan de transition est essentiel à la pérennité de la pratique et à la sécurité financière de votre famille dans le futur. Il n'existe pas de boule de cristal pour prédire exactement ce qui vous arrivera dans le futur. La vie suit son cours! Avec un peu de préparation, d'accord avec beaucoup de préparation, vos chances de succès sont bien meilleures. Cette présentation vise à faire le point sur la complexité de l'achat et de la vente d'une pratique et donne des exemples de domaines qui doivent être considérés durant la négociation de l'achat-vente.

Let's begin with some insights from owners of Well-Managed Practices®. The top considerations in selling their practice include:

1. The price
2. The buyer
3. A smooth transition for clients and staff
4. Job security for the team
5. Being able to continue to practice if I choose to
6. Retaining the real estate to maintain the rental income
7. Being required to continue to practice
8. Telling my employees I'm selling
9. Selling the real estate with the practice

They also recommend taking these day-to-day steps to ensure you achieve a successful transition/sale:

Whether the sale of your practice is imminent or many years in the future, start planning now to ensure you arrive at your desired destination. While you may not have all the answers at this point, and the answers might change based on future events, do your best to develop a plan based on what you know today. Start with these questions.

How much are you selling? Are you planning incremental sales to a co-owner, an associate or a practice manager over a period of time? Or, are you selling 100%?

What's your practice sale timeline? Will an incremental buy-in start in the next few years, more than five years, or even later? When do you plan to exit ownership completely? Your timeline drives your exit: map it out on paper, so you know where you're headed.

If you own the real estate, what's your timeline? Will you sell the building when you sell the practice, or will you retain ownership of the building for some time? When will the practice buyer have the opportunity to purchase the real estate? If the practice buyer isn't interested in purchasing the building, what other options do you have for selling this asset?

Who will buy your practice? Popular options include:

Current co-owner. He or she already has a handle on it – are they ready to completely take the reins?

Current associate, practice manager, or other employee. You'll need a mentorship program that ideally begins about three years ahead of the scheduled buy-in/buy-out. If you have a shorter timeline to work with, you'll need an accelerated program. Don't underestimate the importance and benefit of mentoring your buyer, so he or she is confident, comfortable, and doesn't get cold feet at the last minute.

Future associate, practice manager, or other employee. Plan to work with the future owner at least three years before offering a buy-in, so all parties can assess compatibility. This exit route also drives future hires. The interview process must include a discussion about the potential for ownership and ask whether the candidate has an interest. If the candidate doesn't want to own a practice, you may need to keep looking depending on your sale timeline.

Outside independent practitioner. Prepare your practice to ensure it's an attractive investment. Consider how you'll find the buyer – will you advertise the practice yourself, or work with a practice broker? If you plan to work with a broker, research the various options to find a good match.

Corporate consolidator. Thirty-three percent of Benchmarks participants now say a corporate entity is the likely buyer for their practice. If this applies to you, research the parameters and metrics that define an attractive investment for each of the consolidators, and take the necessary steps to ensure your practice meets the requirements. In general, they're seeking 3 to 4 plus doctor practices with $1.2 million plus in revenue, and at least 16% EBITDA (earnings before interest, depreciation and amortization). There are other considerations too, so do your homework.

If you're planning a gradual buy-in, will you finance part, or all, of the purchase? Consider the loan terms you'll offer. Loans are commonly financed over 7 to 10 years, with an interest rate tied to the buyer's down payment and the prime rate of interest. For example, with a 20% down payment, the interest rate might be prime plus 1.5 to 2 percent. The rate goes up with less down. There are companies who will finance partial buy-ins, so ask the buyer to research his or her options.

Your transition plan must also consider the impact of taxes on the sale proceeds. Meet with your tax accountant/tax attorney to discuss the ramifications of a partial or full practice sale. Ask whether the practice's business structure is optimal for minimizing taxes. If it's not, ask for advice about making a change and the required timeline to reap the full benefit of the change. For example, converting from a C to an S Corporation requires 5 years to realize the full benefit. Get an estimate of the tax you'll pay on the sale proceeds and how much you'll have left after taxes. Ask for strategies to minimize the tax you'll owe on the sale.

Tom McFerson, CPA, ABV, of Gatto McFerson CPAs in Santa Monica, CA says, "Sellers spend so much time calculating their personal income tax exposure that they overlook possible taxes at the entity level. Depending on the state you live in, there may be some tax generated at the corporate or LLC level. For instance, in California, there is a 1.5% Franchise Tax on the taxable income of the corporation. The gain on the asset sale of a veterinary practice would be considered taxable income. As an example, a practice asset sale that generates a combined ordinary/capital gain of $1 million would generate a corporate tax of $15,000 in California."

Another important part of your transition plan is updating your personal plan for financial security. Set a target time frame when you'd like to retire. Estimate your income needs to support your desired retirement lifestyle and the investments you'll need to generate that income. Inventory your financial assets and determine the role your practice plays in your financial security. Set a target practice value, so you know what you're aiming for and develop a plan to get there.

And, don't forget to craft your post-sale professional and life plan. If you're planning an incremental buy-in, what medical and management responsibilities will your new co-owner take off your plate? Will you continue to work the same schedule, or will you reduce your hours during the transition? If you plan to reduce your hours, discuss your desired work schedule during the pre-sale planning so that everyone is on the same page with no surprises. If you're selling 100% of the practice, will you continue as an associate, and if so, what's your desired work schedule and for how long?

As far as your personal life plan, many owners spend years directing a huge portion of their time, energy, and interest on their business, leaving little time and energy for much else. Once you transition out of the practice, what would you like to do with the rest of your life? Perhaps you want to relocate and practice part time. Maybe you'd like to teach and share your knowledge and skills with future owners, veterinarians, or technicians. What if you pursue a new career completely outside of veterinary medicine? Now you have time to travel, spend more time with family, volunteer, golf, or pursue anything else under the sun. Maybe you'll learn a new skill like painting or rock climbing. Retirement living is about more than money, so think about what you want your life to look like and what will make you happy.

Now for some pitfalls to avoid in a practice sale, courtesy of Benchmarks 2016 contributors Charlotte LaCroix, DVM, JD and Karl Salzsieder, DVM, JD.

Equipment contracts – many sellers aren't aware of how equipment leases, loans and long-term contracts are handled at a sale and find out at closing. Biggest problem? The seller may not be able to fully transfer equipment or construction loans, equipment leases, and long-term contracts such as reference labs, credit card machines, etc.

Unexpected competition – there's a problem when a practice buyer doesn't fully assess the competitive risks of what the seller will do after the closing. It's not uncommon for a former practice owner to decide to continue practicing in one form or another and compete with the buyer, thereby interfering with the transfer of the goodwill of the practice.

Late liabilities – buyers think that because a particular sale is structured as an "asset" sale and not a "stock" sale, that they can't incur liabilities from the operations of the business before closing when the seller owned and operated the business. Wrong! Under "successor liability" doctrine, the buyer may actually be responsible for certain pre-closing liabilities – anything from wage law violations and environmental issues to unpaid taxes.

Too-friendly financing – sellers think a private buyer will get 100% financing. Because they're uncomfortable asking for proof of the buyer's financials, they trust on a handshake and someone's good word that they'll be paid 100% cash. Trust . . . but verify.

Unexpected death – no one likes to think about the practice owner's sudden death or disability, but everyone should plan for it. You want two-tier ownership, so associates left at the practice can continue their work and keep the doors open while a buyer is found to get assets for surviving family of the deceased. Every week a practice is closed, the value drops – with a negative impact on the survivors' future. Solo practitioners should have a plan for relief doctors to keep the practice going. Research your state's rules regarding surviving spouse's rights to operate the practice after the death of the principal doctor. Some states allow one year only, which may force a fire sale if the practice doesn't sell in a "reasonable" three to nine months.

In case something goes wrong – all parties to a practice sale need a strong Buy-Sell Agreement to avoid conflicts down the road. Sudden disability, usually for physical reasons, requires presale planning as it relates to practice valuation coupled with management follow-up to maintain a reasonable sale value.

Items to consider for a Buy-Sell Agreement -

What is included in the sale/purchase (assets, stock, practice, real estate)? What valuation methodology will be used to value the practice and what is the price?

What portion of the practice will be sold/purchased (partial sale or 100%)? When will the sale/purchase take place?

How will the purchase be financed? Outside financing, or is seller financing the purchase? If seller is financing, what are the loan terms (down payment, interest rate, length of loan)?

Define those who will not have voting rights (i.e. spouse, ex-spouse, family members, heirs, estates, executors, trustees, trusts, beneficiaries, equity members, members, shareholders, interest holders, directors, officers, managers, affiliates, pledges, creditors, assignees for the benefit of creditors, receivers, trustees in bankruptcy, representatives, successors, assigns, and/or agents).

How will partner/shareholder disagreements be handled? **Example:** If the owners have irreconcilable differences, and instead of a liquidation of the practice, any minority shareholder who is a party to such irreconcilable differences shall sell his/her ownership interest.

How often will the terms of the Partnership/Shareholder/Operating Agreement be revisited? **Example**: The Partnership/Shareholder/Operating Agreement will be revisited anytime there is a sale/partial sale of the practice, and every 5 to 7 years.

How would complete disability affect ownership? **Example**: The disabled owner will be required to sell, and the remaining owners will be required to buy the disabled owner's interest in proportion to their current interest after one year of disability. The disabled owner will receive full compensation for a specified period (usually through the standard elimination period of a disability insurance policy). Once disability insurance benefits begin, the disabled owner's compensation during the remainder of the year of disability will be limited to return on investment.

How would partial disability affect ownership? **Examples**: In the event of partial disability, the veterinary and management compensation of the disabled owner will be modified to reflect a reduced work schedule. An owner must work an average of *four days per week* to retain full ownership benefits if he/she is an owner for *less than ten years*. An owner must work an average of *three days per week* to retain full ownership benefits if he/she is an owner for *ten years or longer*. An owner must maintain a minimum level of production to remain an owner. If an owner wishes to work less than the required amount to retain full ownership benefits, a reduced percent of return on investment may be negotiated.

How would divorce affect ownership? **Examples**: If an owner is getting a divorce from a spouse who is also an owner, both spouses will continue to own and operate the practice in the same way as prior to the divorce; **OR**, one spouse will purchase from the other all of the shares in which he/she has an interest. Failure to do so allows the remaining owners to purchase the spouse's interest in proportion to their current interest; if an owner is getting a divorce from the spouse who is not an owner, the practice shall not be responsible for the cost of the valuation.

How would bankruptcy affect ownership? **Example**: If an owner has filed for bankruptcy, all other owners may elect to purchase the affected owner's interest in proportion to their current interest.

How would death affect ownership? **Example**: The deceased owner's estate will be required to sell, and the remaining owners will be required to buy the interest held by the deceased owner's estate in proportion to their current interest. The deceased owner's estate will finance any cost in excess of insurance proceeds over no more than *seven* years, with a *20% down payment* at *prime plus 2%,* adjusted annually on the anniversary date of the contract. There will be no prepayment penalty. Insurance may be owned to finance a purchase due to death. Discuss ownership and responsibility for payment with your attorney.

Voluntary termination. **Example**: The remaining owners will have the right of first refusal to purchase the departing owner's interest in proportion to their current interest. The practice will be valued as of the date of notice using the formula described in Item 2 (*What is the price*?). If the terminated owner has been an owner for *ten or more years*, he/she will receive 100% of the appraised value. If the terminated owner has been an owner for *less than ten years* (choose one of the following), 1) A vesting schedule of *10% per year* will be applied to any appreciation; or 2) the departing owner will receive only principal payments; interest payments will be forfeited; or 3) All principal and interest payments will be forfeited. If the voluntary termination results in an early disposition of the installment sale, the repurchase price will be net of whatever tax costs the original seller incurs as a result of the early disposition of the installment sale. The purchase will be financed by the departing owner over no more than *seven years, with a 20% down payment at prime plus 2%,* adjusted annually on the anniversary date of the contract. There will be no prepayment penalty. Payments will begin twelve months after the date of notice.

Retirement. **Example**: The remaining owners will purchase the departing owner's interest in proportion to their current interest. The practice will be valued as of the date of notice using the formula described in Item 2 (*What is the price*?). The purchase will be financed by the departing owner over no more than *seven years, with a 20% down payment at prime plus 2%,* adjusted annually on the anniversary date of the contract. There will be no prepayment penalty. Payments will begin twelve months after the date of notice.

Involuntary termination for cause. Reasons for termination could include: disability, impairment, ethics, illegal acts, etc. This should be discussed in detail with your attorney, particularly as it may or may not apply to the involuntary termination of the controlling owner. **Examples**: The involuntarily terminated owner's interest will be purchased by the remaining owners in proportion to their current interest. The practice will be valued as of the date of notice using the formula described in Item 2 (*What is the price*?). If the involuntarily terminated owner has been an owner for *five or more years*, he/she will receive *100%* of the appraised value. If the involuntarily terminated owner has been an owner for *less than five years* (choose one of the following): 1) A vesting schedule of 20% per year will be applied to any appreciation; 2) The departing owner will receive only principal payments; interest payments will be forfeited; or 3) All principal and interest payments will be forfeited. If the involuntary termination results in an early disposition of the installment sale, the repurchase price will be net of whatever tax costs the original seller incurs as a result of the early disposition of the installment sale. The purchase price will be financed by the terminated owner over *no more than seven years, with a 20% down payment at prime plus 2%,* adjusted annually on the anniversary date of the contract. There will be no prepayment penalty. Payments will begin twelve months after the date of notice.

Covenant not to compete. **Example**: A Covenant Not to Compete will be included in the buy/sell agreement or as a part of your employment agreement. We discussed a covenant covering a period of two to three years. The mileage would depend upon the density of the population; we discussed the distance of _____ miles. Discuss this with your attorney; he/she will advise you of acceptable restrictions in your area. All owners agree that a violation of the Covenant Not to Compete will result in an automatic forfeiture of all payments attributed to goodwill.

Confidentiality clause. A Confidentiality Clause will be included in the buy/sell agreement or as a part of your employment agreement. Include a clause prohibiting any person who has ceased to provide services to, or on behalf of, the Practice to directly or indirectly use or disclose any trade secret, proprietary or confidential information, and/or know-how of the Practice.

Non-solicitation clause. A Non-solicitation Clause will be included in the buy/sell agreement or as a part of your employment agreement. Include a clause prohibiting any person who has ceased to provide services to, or on behalf of, the Practice to take away, divert, and/or interfere with any client, customer, account, business, and/or patronage of the Practice for a period of __ years

Owner compensation and management responsibility. **Examples**: An owner must work an average of *four days per week* to retain full ownership benefits if an owner for *less than ten years*. An owner must work an average of *three days per week* to retain full ownership benefits if an owner *for ten years or longer*. If an owner wishes to work less than the required amount to retain full ownership benefits, a reduced percent of return on investment may be negotiated. An owner must maintain a minimum level of production to remain an owner. Compensation is commonly based on three components: veterinary production (based on production), practice ownership (ROI based on share of ownership), and management time and effort based on 1% to 3% of the total practice gross and allocated among the five areas of management (Employee Development, Client Development, Financial Management, Medical Development, and Facilities, Equipment and Technology Development). The time and effort for each area should be stated as a percentage of total management. The management fee would be distributed among the areas based on their respective values.

How will the business be structured (LLC, S Corp, Partnership, etc.)?

Other

Work requirement to retain full ownership benefits. Minimum number of hours or minimum production required?

Insurance coverage. Who will be the owner and beneficiary of life insurance policies on the owners' lives?

Corporate redemption versus cross purchase. Discuss the use of insurance to fund corporate redemptions or cross purchases with your attorney after your selection of a business structure.

This information is intended to provide the reader with general guidance in practice succession matters. The materials do not constitute, and should not be treated as, appraisal, tax, or legal guidance or technique for use in any particular succession situation. Although WTA Veterinary Consultants made every effort to assure the accuracy of these materials, we don't assume any responsibility for any individual's reliance on the information presented. Each reader must independently verify all statements made in the material before applying them to a particular fact situation and must independently determine whether the succession technique is appropriate before recommending that technique to a client or implementing such a technique on behalf of a client or for the reader's own behalf.