Buy-Sell Negotiations: Ethical Disclosures or Buyer Beware ©

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Buying or selling a veterinary practice generally is a long and arduous process. Preparation and a good lawyer are key to smoothing the bumps along the way.

I. PLANNING

How well you plan determines whether you will control the process or vice versa. Beyond identifying what is to be sold and the purchase price therefore, here is an overview of the main planning issues:

A. What Seller should be doing. Future retirees should note that it can take a decade to properly prepare a practice for sale.

- **Tax.** Find out how the sale price will be taxed. Tax planning may require transformation of the practice legal structure and long waiting periods to optimize tax on sale. Bear in mind that the buyer may not accept the structure you wish to use for the transaction (e.g., he may prefer to buy assets rather than an interest in the practice entity.)

- **Practice Appraisal.** To increase practice profitability and sales price, it may be worthwhile to get an appraisal. Implementing the appraisal's recommendations may take several years. From the buyer's perspective, a purchase without an appraisal may mean the practice does NOT have the cash flow to fund the purchase payments. If the buyer defaults on the payments, seller may have to take back practice, long after retirement.

- **Cleaning Up.** Consult with your lawyer to see if there are any liabilities that should be taken care of before the sale (e.g., settle a claim). You also need to address any personal guarantees you have given to the business, and third party claims on any assets to be transferred (such as spouse and secured lenders). If the practice entity owns the real estate, you may need to divest it (at what tax cost?) back to yourself or another entity you own because the buyer may be unable to afford to buy both.

- **Financing.** Many potential buyers can't afford to pay cash and can't get bank loans on acceptable terms. Consider whether you should provide financing by taking buyer's promissory note (secured of course) for a portion of the purchase price.

B. What Buyer should be doing. Buyer's planning phase usually is much shorter than seller's. Try to minimize preparation expenses until you are reasonably sure that you have a deal with the seller. If the deal is aborted, you want to be as little "out-of-pocket" as possible.

- **Hiring Counsel.** When hiring counsel, trust your instinct. If you don't feel comfortable with him or her, get another one, there are plenty around. You find a good lawyer the same way you find a good doctor: by word of mouth. Your lawyer should be at least as smart as you are. Avoid lawyers that not nothing about assisting buyers purchase medical practices.

- **Tax.** Find out how the sale can be structured to minimize taxes down the road for the new owner(s) and the practice, including taxes when you sell or withdraw from the practice. (Remember every buyer is destined to be a seller.)

- **Due Diligence.** You don't buy a house without visiting it, nor a car without a test drive. Buyers need to spend time at the practice to "kick the tires." One of the most important goals of due diligence is to make sure buyers are not picking up hidden or poorly identified liabilities. Due diligence allows early detection of potential problems, so that the parties can address them...or separate. Not infrequently, good due diligence leads to a reduction in purchase price.

- **Financing.** If you can't pay cash, you need to line up financing (or be prepared to ask the seller for same) well before the sale.

- **Co-Ownership Issues.** If you are just buying a portion of a practice or joining with other partners to buy a practice, there are many co-ownership issues that need to be addressed. Like marriage, co-ownership works a lot better if the principal terms governing the relationship *before* getting hitched. At least as much time and effort should be allocated to properly establishing *and* documenting your relationship with your partners, as to the purchase itself.

- **Investment Vehicle/Practice Structure.** Unless you are buying into a pre-existing structure, consult with your lawyer to find the investment vehicle or practice structure best suited to fulfill your tax, financing and (co)ownership goals. (In making this choice, do not omit to factor in you succession or exit strategy.) Even if buying into a pre-existing structure, be aware of the consequences. For example, stock purchases are riskier than asset purchases because all of the liabilities of a corporation automatically are transferred with the stock, whether or not such liabilities were disclosed to buyer.

C. What Seller and Buyer should be doing *Together*.

- **Employees.** The practice's employees constitute its most valuable asset by far and it's in the interest of both parties that the transition take place smoothly. For the buyer, smooth transition is critical, since the departure of one or more key employees can cripple the practice. While legally (to avoid trailing liabilities), the buyer will insist that all employees be terminated prior to the sale (and to the extent the buyer wants to retain them, rehired after the sale), it is up to the parties to work together to ensure that the ownership change disrupts the employees as little as possible.

- **Contracts.** In asset sales where contracts are to be transferred (e.g. real estate and equipment leases), the consent of the other party to the contract is required. Obtaining such approvals is often easier when both buyer and seller approach such other party together (although as a contractual matter, it is almost always the seller's responsibility to get these consents).

III. NEGOTIATING THE DOCUMENTS

A. Preliminary Documents. At some point during the preparatory stage, the parties usually negotiate some form of preliminary document which can range from: (a) a short letter of intent, pursuant to which the parties agree to negotiate in good faith with each other (in some cases exclusively) and confidentiality; to (b) a detailed memorandum of understanding detailing the process for going forward; to (c) an at least partially binding detailed letter of offer which sets forth the main terms of the deal. The parties should make absolutely sure they understand to what extent these documents bind them to go forward, and what liability, if any, a party will incur if he withdraws from the deal.

B. Purchase and Sale Agreement. While the preliminary documents set forth an intent, a process or a framework, the purchase and sale agreement (called stock or asset purchase agreement depending upon the transaction) is the contract in which the buyer binds himself to purchase the practice and pay the price, and the seller binds himself to sell the practice, in each case subject to a limited number of conditions precedent to closing the deal. Some conditions precedent are applicable to both parties obligation to close (e.g. no litigation exist challenging the transaction). Some are applicable to only one party (such as buyer obtaining satisfactory bank financing).

Other than the price and conveyance language, the most important clauses of the purchase agreement are seller's representations and warranties, pursuant to which seller makes a series of declarations about the business (there are no hidden liabilities, there is no outstanding litigation against the practice; all inventory is saleable in the ordinary course, etc.) These provisions are designed to protect the buyer in case the practice isn't what it appears to be, but the devil is in the wording, and both parties should make sure that they are comfortable with the language.

Another key clause is the non-competition provision (a.k.a. restrictive covenant) which prohibits the seller from competing with the practice for a certain period of time (e.g., five years) within a certain radius (e.g., 15 miles). This is an important provision to protect the practice's goodwill.

III. TOWARDS CLOSING

Signing the purchase agreement means that the parties commit to consummate the transaction once all of the conditions to closing have been satisfied. Closing the transaction means actually transferring legal title to the shares or assets and paying the purchase price. Between these two dates, the parties and their lawyers do what is necessary to ensure that the closing conditions in the purchase agreement for which they are responsible will be satisfied by the closing date. (For example, buyer may have to obtain bank financing and seller get certain third party consents to the deal.)

In many cases, the signing of the purchase agreement and the actual closing of the transaction take place simultaneously, in which case there are no closing conditions.

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The preceding was merely a simplified overview. It seems that there are a billion issues and details that seller and buyer must keep track of when selling and buying a practice. That's why competent legal advice is crucial. But if you feel overwhelmed, just ask yourself how you'd behave if the transaction involved a house or a car. Usually the solution will come to you as if by magic.

PRACTICE ENTITY-WHICH ORGANIZATION IS BEST FOR YOU AND WHY IT MATTERS ©

Choosing the correct structure for your veterinary practice is an important decision with consequences reaching far into the future. Selecting your practice structure is definitely *not* a "do it yourself" project. Substantial tax, legal and accounting expertise is required. Veterinarians nevertheless need to stay active in the process to ensure the experts' narrow technical proposals get folded into a coherent plan that reflects *your* needs and goals.

• **It's Mostly About Tax.** Tax considerations are the primary drivers in choosing a legal structure for a veterinary practice. The two key aspects are taxation of income/profits and taxation upon the sale or transformation of the practice. Don't paint yourself into a corner by choosing a business structure without establishing a succession or exit strategy. Exit strategies should focus not only on your richly deserved retirement, but also on contingencies such as death or disability). Since the transformation of an existing business structures in anticipation of a sale or the buy-in of a new partner usually triggers adverse tax consequences, it is usually better to choose an initial structure with the necessary flexibility to handle new arrivals, departures and divestitures at minimum fiscal cost.

• **Liability Shield.** In some structures such as partnerships, the owners are personally liable on their individual assets for the debts of the business. In others their personal assets generally are not at risk. Business structures, however, do not insulate veterinarians from liability arising from malpractice claims.[1] But the shield works for almost all other claims, which in our litigious society are increasingly frequent. Unless you are an equine or food animal veterinarian, you generally have greater exposure to claims from your client's "slipping and falling" in your hallway, than malpractice.

• **Flexibility and Formalities.** Some structures allow more management flexibility and/or are less burdensome to administer than others. Veterinarians generally tend to ignore formalities which is a serious mistake. Courts regularly have looked past the liability shield and held owners personally liable when the owners have failed to observe the formalities separating their personal affairs from those of the practice entity.

AN OVERVIEW

The accompanying table compares the more common business structures from a liability, management and formality perspective (in simplified form). Following is a brief and much simplified overview of the tax characteristics of each entity.

1. Sole Proprietorships. Since sole proprietorships are not legally separate from the single owner, there is no separate tax return. The practice's profits are included in owner's total income and are taxed at his ordinary income tax rate. In addition to federal and (if applicable) state income tax, the owner must also pay self-employment tax equivalent to the payroll taxes due as if the owner were an employee of the practice.

Upon the sale of the sole proprietorship practice's assets, the IRS will recapture all depreciation/amortization deductions taken by the owner/seller thereof and tax such amount at the seller's ordinary income tax rates. In the unlikely event that any gain remains on the assets (after adding back any depreciation/amortization to their respective "bases"[2]) they will be taxed at the lower 20% long term capital gains rate (assuming the relevant holding period is met).

The buyer receives a "step-up" (increase) in his basis in the assets proportional to the amount of (purchase price allocated thereto) allowing him to re-depreciate/amortize them. Thus, asset sales usually are a better deal tax-wise for the buyer than for the seller, and all other things being equal, buyers will prefer to purchase assets rather than stock (in a C corp).

2. Partnerships. Partnerships are "pass-through" or "flow-through" entities for tax purposes, meaning that each partner includes in his own taxable income the profits (or losses) of the partnership, which are taxed as ordinary income at the partner's individual rate (much like the owner of a sole proprietorship). Note that each partner's share of partnership income is taxable each year, whether such share was distributed to the partner or retained in the partnership. If the latter, then the partner may not have the cash to pay the tax.

A consequence of the pass-through principle is that the sale of partnership interests are treated for tax purposes similarly to the sale of the underlying assets of the partnership (i.e., the assets are subject to depreciation recapture as in sole proprietorships).

3. Corporations. All corporations must file separate tax returns.

- "S" Corporations. "S" corporations are corporations that elect to be taxed as a partnership. As "pass-through" entities, profits will be taxed in the hands of the shareholders whether distributed or not. An advantage of S corporations is that shareholders may take a portion of their profits as "S corporation profit," free of payroll or self-employment tax (i.e., subject only to income tax). Profit corresponding to what the veterinarian shareholder would have earned as an employee is subject to payroll taxes in addition to income tax. (Sole proprietorships on the other hand must pay self-employment tax on all profits.) S corps are popular with veterinarians for this reason.

- "C" Corporations. "Plain vanilla" corporations (called "C" corporations to distinguish them from "S" corps) are not "pass-through" entities and are subject to corporate income tax, usually at the 35% rate for veterinary practices.[3] Distributed profits (dividends) are taxed as ordinary income in the hands of the shareholders. This "double taxation" discourages the distribution of C corporation profits. On the plus side, C corp profits are not taxed until distributed, pension plan contributions are not subject to the S corp limits, and employee-shareholders' health benefits are not taxed. Veterinarians wishing to maximize their benefits will choose a C corp over an S corp.
  If the holding period requirement has been met, the sale of C corporation stock is taxed at the favorable 20% long term capital gains rate. The buyer does not receive a step-up in the basis of the underlying assets since he is buying the corporation stock. (The buyer can under certain circumstances elect to treat the transaction as an asset sale for tax purposes (a.k.a. a Section 338 election).)

4. Limited Liability Companies. Limited Liability Companies are very quite tax-wise. Single member LLCs can elect to be taxed either as a C corp or a sole proprietorship. Multi-member LLCs can elect to be taxed either as a C Corp or a partnership. Unfortunately, not every state allows veterinarians for form LLC (ie, California).

5. A Word Regarding Real Estate. If the practice owns its own real estate it's better placed in a separate entity held by the owner(s) or held individually by the practices owner(s). This allows the owners to receive rent (which will be deductible from the practice's income). Moreover, placing the real estate and the practice in the same legal entity frequently leads to problems because the buyer can't afford to buy the real estate in addition to the practice.

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Choosing the correct business structure for your practice is important. Don't treat it lightly.

SIMPLIFIED PARTIAL COMPARISON OF DIFFERENT BUSINESS STRUCTURES
(*Ex* tax issues)

Structure or Entity Type\Issue	**Liability**	**Formalities/Flexibility**
Sole Proprietorship No entity; business co-mingled with personal assets	**No liability shield**	None. Just open your door and you're in practice!
Corporations ("C" or "S" Corp) A Professional Corporation ("PC") is identical to a C Corp in all respects except that only members of the same profession (e.g., vets) can own its shares	Shareholder not liable for debts/liabilities of corporation (unless "corporate veil is pierced" because shareholders fail to separate their personal affairs from corporations (e.g. by ignoring formalities)	Must file documents with state secretary of state. Formalities are the most cumbersome of all entities. Less formal flexibility re management/profit sharing issues
Limited Liability Company (LLC) (Created to provide more management flexibility than S Corp and "pass through" tax treatment)	Member not liable for debts/liabilities of LLC (subject to piercing corporate veil doctrine)	Must file documents with state secretary of state; but management, profit sharing can be flexible.
General Partnership[4]	Partners liable for debts/liabilities of Partnership; **no liability shield**	Must file documents with state secretary of state, but management; profit sharing can be flexible.

[1] Salvation lies in adequate malpractice insurance.

[2] The basis of an asset is it's original cost to the owner, as adjusted pursuant to IRS rules.

[3] Because veterinary practices usually are personal service corporations.

[4] Limited partnerships are different from general partnerships. An LLP generally is formed among several limited partners who are normally passive financial investors and one general partner responsible for managing the enterprise. Limited partners normally are not liable for the debts/liabilities of the LLP, whereas the general partner is. Contrary to the motion picture business, real estate or oil and gas exploration, LLPs may not be appropriate for a veterinary practice where all the members are actively engaged in the enterprise.