NATIONAL VETERINARY LAW GROUP AT
MANDELBAUM BARRETT

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9 Essential Considerations for an Associate Buy-In

Whether you are a seasoned veterinarian considering retirement or a young veterinarian looking to join an established practice as a co-owner, such buy-in transitions require careful consideration. Our legal team of experienced veterinary attorneys will assist you in every aspect of the transaction from determining how the acquisition should be structured and negotiating the transaction terms to closing the deal.

Associate buy-ins often require the parties to consider issues beyond selling equity in the business. By way of example, the parties may need to negotiate new employment agreements that reflect the new structure or define appropriate restrictive covenants. Similarly, the associate buying-in may want a right of first refusal or right of first offer in connection with the sale of the practice. Negotiating a new or updated operating or shareholders' agreement will also be necessary to define the rights and responsibilities of the new practice owners, as well as the existing owner.

Below we have compiled several key considerations which will likely play a role in every associate buy-in regardless of whether you are the associate buyer or the seller. We have organized the issues in a way that should follow the natural progression of an associate buy-in transaction.

Step 1: Conduct a Practice Valuation

Agreeing on the value of the practice for a buy-in is an important step in getting a transaction off the ground. It is essential to get a fair market independent appraisal of the practice at the outset to avoid protracted negotiations on the issue. If the parties disagree with the valuation, they can submit their reasoning and engage in further discussions. Both the seller and associate buying-in may consider having their own accountants weigh in on the valuation. The following factors are generally considered in valuing a practice: location; the buyer's goodwill; years in existence and stability; client demand; the quality of the staff; and the practice's revenue growth. After the parties have agreed upon the practice value, and the percentage of ownership interest that the associate will buy, the next issue to consider is the associate's financing options.

Step 2: Understand Financing Options

How an associate buy-in is financed is a key determinant of long-term cash flow, and ultimately, the success of the deal and of the practice. The buy-in is often financed by a commercial lender or by the selling doctor. Since the veterinary industry's low default rate encourages lenders to pursue a business relationship with veterinarians, an associate buyer will likely receive the necessary financing from a lender for a transaction he or she wishes to pursue. However, a bank will require the associate to offer collateral for the loan, or require a first lien position on the assets of the practice. Most sellers do not like this arrangement because if the associate defaults, the bank can foreclose on the entire practice, not just the associate's share. In essence, the bank will require the seller to "guarantee" the associate's promissory note. Another option for paying the purchase price is "seller financing." Under this scenario, the associate buyer will pay the purchase price over time to the seller and execute a note to evidence this debt. This is, however, less advantageous for a seller as payouts can often take years. On the other hand, when the seller finances the deal, he or she has more "skin in the game" since the seller wants the associate buyer to make payments, and does not want to lose money on the deal.

Step 3: Negotiate a Letter of Intent

Rather than immediately incurring the expense of negotiating and drafting a contractual agreement, both parties should consider entering into a letter of intent (also known as an "LOI"). This is a preliminary document which sets out the key terms of a proposed transaction. An LOI is usually non-binding, which means the parties are not obligated to complete the proposed transaction. The purpose of an LOI is to ensure that the parties agree on important terms such as purchase price, payment terms, due diligence, and closing contingencies before investing further resources negotiating the deal. Signing an LOI signals the parties' willingness to negotiate exclusively for a set period as the parties work to finalize the deal. Further, attorneys can use the LOI as a basis to quickly and efficiently negotiate and draft legally binding documents. Because the parties have agreed in advance to certain key points, less is left open for negotiation, and the chances of the deal falling through are reduced.

Step 4: Engage in Due Diligence

Before an associate buys in to a practice, thorough due diligence must be completed. During due diligence, the associate and his/her lender will carefully assess the benefits and liabilities of the proposed acquisition. This entails inquiring into all relevant aspects of past, present and future business of the practice. Due diligence occurs after an LOI is signed and may be limited to an agreed-upon period or may continue through the closing date. By way of example, due diligence often includes running lien and judgment searches on the practice, which can reveal unpaid taxes, debts, or legal judgments; financial due diligence, which includes a deep dive into the seller's cash flow, financial statements, and tax returns; and legal diligence, which includes an exhaustive review of seller's contracts, governmental permits, professional licenses, insurance coverage, employee data, litigation, corporate formation documents and ownership, employee benefits, equipment, along with a host of other issues. A thorough due diligence process is in both parties' best interests. An associate does not want to overpay for the practice or inherit an unexpected liability or problem, and the seller does not want to indemnify the associate for violations or inaccuracies in the representations and warranties the seller makes when selling the practice.

Step 5: Identify the Necessary Agreements

Once the parties have agreed upon the business terms of the buy-in, the proper agreements will need to be drafted in order to effectuate the buy-in. Typically, these include the purchase agreement, an operating or shareholders' agreement, and employment agreements. Each of these agreements is explained in further detail below.

Step 6: Negotiate a Purchase Agreement

The type of purchase agreement that is drafted will depend on the legal entity structure of the practice. If the practice is a limited liability company ("LLC"), the agreement will be a membership interest purchase agreement. If the practice is a corporation, the controlling agreement will be a stock purchase agreement. Regardless of the type of purchase agreement in place, such agreement will need to include the purchase price, payment terms and/or a loan contingency, the representations and warranties of the seller and the buyer, a list of other documents and information to be delivered at the closing, as well as other key terms such as representations of the selling veterinarian about the pre-closing operation of the practice, restrictive covenants, transition obligations, closing contingencies, and indemnification obligations.

Step 7: Negotiate an Operating or Shareholders' Agreement

The parties also need to agree upon the terms of their "new partnership." Depending on the legal entity structure of the practice, this agreement will either be an operating agreement, if the business entity is an LLC, or a shareholders' agreement, if the entity is a corporation. Some of the key terms that should be addressed in either type of agreement include ownership and voting rights; management responsibilities; distributions; restrictions on transfer/sale; restrictive covenants; limitations on liability; indemnification; meetings of the partners, and dissolution. The operating or shareholders' agreement should also address exit strategy issues which are set forth in the buy-sell section of the agreement. The parties will need to establish under what circumstances an owner (or his/her estate, if deceased) would be forced to sell his/her ownership interest, and on what terms. Upon the occurrence of certain triggering events, an owner should be required to sell or offer to sell his/her ownership interest to the remaining owners or the company. This is particularly relevant in the context of an associate buy-in because the operating or shareholders' agreement may be structured so the associate eventually has the right to purchase the remaining equity in the practice, which will allow a doctor wishing to retire the freedom to exit the practice entirely. To this end, the operating or shareholders' agreement should also identify a formula to value the selling doctor's ownership interest and provide for payment terms (e.g., use of life insurance proceeds, the length of time for payment, and the applicable interest rate).

Step 8: Establish Employment Terms and Agreements

Each of the doctors should have written employment agreements which describe how they will be compensated and what benefits they will receive. Having written employment agreements for all owners will ensure that all parties are being treated equally, and that the terms of employment align with the rights and responsibilities set forth in the operating or shareholders' agreement. Further, a new employment agreement is needed as the associate's prior employment agreement may no longer apply once he or she becomes an owner. Finally, the employment agreements will set forth how each doctor can be terminated for "cause," (e.g., conviction of any felony, suspension, or termination of the doctor's professional license, etc.) which in turn will likely trigger a sale of ownership interest under the operating or shareholders' agreement.

Step 9: Restrictive Covenants

Operating and shareholders' agreements and employment agreements also serve the important function of establishing the restrictive covenants (e.g., non-competition, non-solicitation, and confidentiality) that each doctor must comply with for an agreed upon period of time (e.g., three to five years) in the event their employment with the practice is terminated. It is very important for all parties to understand their partners' future plans. This is especially relevant when a younger associate is buying in to a practice owned by an older doctor. Will the doctor be retiring in the near future? Does the doctor intend to enter into a new business venture upon retirement from the practice? How long can the associate expect his partner to stay employed at the practice? Knowing these details can help both parties negotiate a reasonable and enforceable restrictive covenant, but, more importantly, it can prevent the parties from making a mistake about the status of the business and the seller's intentions for the future. These are the type of misunderstandings that lead to disputes and litigation.

Conclusion

Clearly, there are many factors that need to be considered in an associate buy-in transaction. The issues delineated above are not all-encompassing. Further, all parties, practices, and transactions are different, so the parties should expect different issues to arise during their process. The key is to engage the right legal team that will guide you through this important process. Our veterinary law attorneys have the experience necessary to help you navigate the associate buy-in process and will work to ensure a successful transaction.

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