

Management Service Organization Contracts: Tips for Successful Negotiations

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Last year, the number of management service organizations catering to orthodontists jumped from one to many. The field of publicly traded orthodontic MSOs now includes not only Orthodontic Centers of America (OCA), but also Apple Orthodontix (AOI), Omega (ORTH), OrthAlliance (ORAL), and Orthodontix (OTIX). There are also privately held companies such as New Image that offer comparable affiliation packages.

Discussion of the ethical and economic dilemmas posed by MSOs is best left to orthodontists themselves. From a practitioner's standpoint, however, the increasing number of companies and competition for affiliating practices should spell good news. Doctors now have the opportunity to join MSOs that best fit their individual management philosophies, financial needs, and personal styles. And frankly, it's nice to be courted. One client recently told me he felt like a free agent in the NFL—with three companies wanting to fly him (all expenses paid) to their respective headquarters in hopes of convincing him to join their ranks.

No matter what company you choose, how you choose is a process that should include an analysis of your practice, professional, and personal goals from the outset. Thus, you will approach any MSO with a clear plan in mind, and you will less likely be swayed by fast talk and vague promises.

This article discusses some of the thinking we suggest you undertake before looking around, as well as some of the sticky points that have arisen in our MSO negotiating experience.

"No Shop" Agreements

Most MSOs ask that you sign a confidentiality agreement before entering into substantive discussions about the terms of affiliation. Such agreements are quite common in business negotiations, because they are designed to protect confidential business information. So long as the strictures imposed are equally applicable to both parties and are reasonable in scope, such agreements are usually benign and can be entered into without prejudice.

Before signing, however, be aware of a twist that is not so benign: the "no shop" clause. This restriction, which is imposed only on the orthodontist, requires that the doctor consider only the particular MSO's offer and refrain from negotiating with any other MSO for a specific amount of time (sometimes as long as six months). The rationale used by the MSOs is that it will cost them time and money to evaluate your practice and make an affiliation offer. Whether such clauses are legally binding is questionable under the doctrine of consideration (See Note 1), but our advice is not to sign them.

We find it disturbing and a sign of bad faith that most MSOs try to entice doctors into signing "no shop" agreements, especially because the restriction is not mutual. The MSO does not promise to refrain from negotiating with competing practices in your area while you spend your time and money considering the MSO and its offer. What do you suppose would happen if you made each patient sign a "no shop" agreement before the consultation? Shopping is an American institution, and in a market of increasing competition, it is patently offensive to us that an MSO would seek to keep potential affiliates in the dark about its competitors. We believe the more open the discussion of the specific

terms of each agreement, the better each MSO will define itself in the marketplace. Orthodontists of like mind will then be able to affiliate for reasons other than simply money or treatment style.

If all doctors refuse to sign "no shop" agreements, they will go the way of the dinosaurs. If an MSO absolutely insists on such a clause, you should insist on limiting the length of time the restriction is in effect. Before signing, talk to your friends and colleagues who have already affiliated with one MSO or another, and try to compare their offers.

Decisions

Your first decision is likely to be: "OK, let's pursue this and see what the MSOs have to offer." Even this decision is not an easy one, and when combined with the pressure of negotiations and the sense that you may be selling your independence as a business owner, it can make for one of the more stressful times in your career. First, know that you are not alone. Sleepless nights and long talks with family and close friends are common to all our clients—through the day of signing and sometimes beyond.

For those who choose to move forward with affiliation, further decisions are at hand. You will find that there are essentially three mechanisms of affiliation: asset purchases, stock purchases, and statutory mergers/reorganizations. In an asset purchase, your practice (PC, PA, LLC, "C" corporation, etc.) sells all its "non-orthodontic" assets to the MSO. Your practice remains the entity through which you practice orthodontics. In the other two mechanisms, you sell or trade all the shares in your corporation for either cash (stock purchase) or shares (statutory merger or reorganization) of the MSO. (See Note 2) You strip the orthodontic assets out of your corporation and pledge them into a new entity licensed to practice dentistry under your state laws. This requires that you complete a number of corporate formalities and usually that you change the name under which you do business.

Some MSOs may be willing to pay you a higher affiliation price under an asset purchase deal because of the tax benefits for the MSO. In fact, tax consequences are exactly why the choice of mechanism is important. Talk to your CPA or attorney and think about your plans. The main reason for affiliating is usually money. But what are your plans for the money—immediate needs, long-term retirement, a blend of these? The affiliation payment may be the single largest contractual payment you ever receive, so well-thought-out tax and estate planning is essential.¹

Practice Assets

The goal of any MSO is to exercise as much control as possible over your practice. One major means of control is through ownership of your "non-orthodontic" assets—your office leases, telephone system, telephone numbers, copying machines, computers, office furniture, and so on. The only assets the MSO will not own or control are those orthodontic assets that must remain in the hands of the doctor under state law.

This arrangement is usually fairly straightforward, except for those assets that you may think of as personal, such as your antique roll-top desk, the signed artist prints, or the original watercolor. Such items may have been purchased by your corporation and would be considered "non-orthodontic" assets, but you may have a personal attachment to them. The way to handle this issue is to make a list of those items and specifically exclude them from the purchase or merger. Should you decide to leave the practice, you can then take the items listed with you. Without such an exclusion, the MSO could properly assert that it owns the items.

Trade Secrets and Non-Competition Clauses

All MSO contracts include various "non-compete" clauses. Such clauses are usually regulated in their scope, since most states require both a reasonable time restraint (such as two years) and geographic restriction (such as within your city). Most "non-compete" clauses are legally appropriate, but many people fail to notice the more sinister "trade secrets" and "remedial" clauses.

The MSO would like you to agree that every piece of information you ever learn about the workings of the company is a trade secret. If this includes MSO-sponsored seminars, during which you receive information included within the definition of "trade secret", you could effectively be stopped from ever practicing orthodontics outside of your MSO agreement (See Note 3).

"Remedial" clauses also limit your ability to practice. For example, three MSOs that we know of require the orthodontist to turn over patient lists, records, charts, and so on (to another doctor, and within the bounds of doctor/patient confidentiality) if the agreement is breached for any reason.

Watch for these clauses, and do not be satisfied that the only limitations on your ability to practice outside the MSO are contained in a two-year, 10-mile restriction. If the trade secrets or remedial clauses are too harsh for your taste, refuse to sign them and require that they be stricken from the agreement.

Service Fees and Practice Profitability

Most MSO contracts define what expenses are to be deemed "practice expenses", as opposed to expenses that are attributable to the orthodontist alone. Pay close attention to this area in the negotiations, because the definition of expenses will have a significant impact on your net share of collections.

You will find that items you may deduct in the normal course of business—such as your automobile, professional development expenses, and license fees—are not considered practice expenses under the affiliation contract and are thus paid by you after the MSO has taken its share of "net" profits. Analyze what this will mean to your bottom line. We have found that most MSOs are willing to negotiate, as long as the doctor meets the expectation of cash flow.

The MSO will examine your practice profitability before proffering an affiliation proposal. Under your definition of expenses, your practice might be 40% profitable; under the MSO's more restrictive interpretation, your profitability might be 50%. Keep in mind that the MSO's objective is to receive a portion of your net profits for 20-40 years, and that a 10% difference in profitability means a significant amount of money over such a period. Use this as a bargaining tool when negotiating your affiliation payment.

The Affiliation Payment

There are essentially three ways for you to be paid for your affiliation: cash, marketable securities, or restricted securities. In addition, some MSOs will offer to have you hold a promissory note, and one affiliation proposal we saw recently included a formulation wherein the MSO used the doctor's own revenues to pay part of the affiliation price.

Our advice is to take the cash. Cash is better than marketable securities in that you need not diversify your investments, pay brokerage fees, or worry about how the stock is doing. The only time securities

might prove advantageous is if you can negotiate to receive them at a discount (that is, below the rate at which they are trading). Some MSOs will offer such a discount, because shares represent public money. An MSO may pay 10 doctors 250,000 shares each to affiliate, then go to the market and announce a new issue of 5 million shares. The trading price normally tends to go down after a new issue, but because the MSO can show increased earnings based on the affiliations, there may be no effect. In addition, any drop in the trading price is spread among all the shareholders.

If you must be paid in shares, try to negotiate a higher payment. Also, spend some time analyzing the MSO's track record, and try to determine which way the trading values might go. This will help you decide whether you want to establish a set price or a discount based on the trading value on the day you close the deal.

Restricted securities are shares that may not be sold on the public market because of government regulation. (In many cases, you can still sell them to foreign individuals for a negotiated discount.) "Locked-up" securities are those you could otherwise sell on the public exchanges, except that you entered a private contract limiting your right to sell.

Before agreeing to receive a significant portion of your affiliation payment in restricted or "locked-up" securities, you should obtain a professional market analysis. It is obviously in your best interest to minimize the period during which the stock is locked up. There is a substantial risk that the trading price could go down during the restriction, and thus your affiliation payment could be significantly reduced by the time you can sell the shares. Unfortunately, it is usually MSOs that have only recently gone public that offer the least tradeable securities.

Another problem with being paid in shares lies in the time value of money. Consider an orthodontist who receives half of his \$1 million affiliation price in securities that he cannot trade for one year. This \$500,000 could have earned 10% during the year, yielding \$50,000 in interest. If the restriction is for two years, the doctor loses \$100,000. Also consider that you will pay the MSO a portion of your collections each month in cash, and thus miss the opportunity to have that cash working for you.

The reason why MSOs pay in restricted securities is twofold: first, many newer companies have neither the assets nor the liquidity to pay every doctor in cash (and remember, public money and shares are "cheap money"); second, the restriction prevents any one affiliate from "dumping" stock on the market and forcing the price down. Both rationales are valid, but neither benefits the doctor. Our advice is to minimize the length of the restriction and to negotiate a higher affiliation price to compensate you for your risk and the time value of your money.

Practice Investments

If you are considering a major practice investment, such as computer equipment, don't make it just before affiliating with an MSO. A large purchase will cut down on your practice profitability and therefore on the affiliation price the MSO is willing to pay. In addition, most MSOs share in practice expenses, because their take is based on net revenues. Once you affiliate with an MSO, you in effect have a new partner—so let the partner pay its share of the expenses.

Extra caution should be taken with investments in computer hardware and software. Most MSOs are trying to standardize the computer systems used by their affiliates, so upgrades made before affiliation may be obsolete from the outset.

If you have recently made investments of \$10,000 or more in your practice, or hold a substantial note

on a recent purchase, discuss this with the MSO early in the game. We have seen an MSO agree to assume a note for an orthodontist while they were in the "courting" stage, but refuse to consider another doctor's note for similar equipment that was revealed late in the negotiations.

Conclusion

Our intent in this article is not to decry the evils of MSOs. We have helped many clients negotiate affiliations with MSOs; as with all good contracts, these deals are beneficial to both parties. Simply stated, MSOs represent excellent practice development and earning potential for young practitioners, and substantial pay-out opportunities for orthodontists seeking to retire. But doctors need to be savvy, educated, and prepared before they begin negotiations. We hope some of these hints will help. □

REFERENCES

1 Callender, T.S. and Callender, R.S.: Financial independence with or without management service, J. Clin. Orthod. 31:442-445, 1997

FOOTNOTES

1 Note 1. "Consideration" is a contractual prerequisite that says "something" must be exchanged for an agreement to be binding.

2 Note 2. Statutory mergers and acquisitions are essentially governed by Section 368(a) of the Internal Revenue Code. These mergers are quite complex and should not be undertaken without the advice of competent counsel.

3 Note 3. Most states have statutory definitions of "trade secrets" and companion statutes that affix some penalty for disclosing such secrets. Trade secrets may not become stale for a long time, and rarely do the statutes impose any "reasonability" standard. If you doubt the relevance of such clauses, consider that Orthodontic Centers of America brought suit against Apple Orthodontix on a trade-secret theory. To fully understand the ramifications of such a provision, consult an attorney who has dealt with these issues in your state.