IN BRIEF

- A review of Government proposals to allow companies to carry on the business of dentistry.
- An examination of some benefits of incorporation and possible limitations on these, such as in the area of clinical negligence.
- Personal responsibilities and duties of Directors are considered.
- How to convert your practice to a company and planning considerations for the company's structure.

Thinking of incorporating your dental practice? – some legal issues to consider

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The Government is proposing a major deregulation to the dental market by removing the restriction which allows only 27 named corporate bodies to carry on the business of dentistry. The Government sees benefits in incorporation for both NHS and private dentistry and in particular by providing wider ranging options for attracting investment. The necessary changes to the *Dentists Act* 1984 would be implemented by an Order under Section 60 the *Health Act* 1999. The latest news from the Department of Health when this was written is that they anticipate consulting on the draft Order by September of this year.

ASSESSING THE BENEFITS OF INCORPORATION

Any dentist thinking of incorporating, would have to examine very carefully with his or her accountant the taxation implications, which are beyond the scope of this article.

The big question is whether the legal benefits of incorporation normally perceived by other business sectors would carry the same weight for dentistry. Some see incorporation as opening the doors to greater access to investment to fund better premises and equipment. Banks may be more willing to lend to an incorporated practice which in theory can offer greater security by not only a mortgage over its premises but also a floating charge over its goodwill and dental equipment and instruments. A company would also have an alternative source of funding by raising share capital from a third party investor.

A company may be attractive for providing a unified structure for practices looking to merge.

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A principal reason for many businesses incorporating is to obtain limited liability for the owners. A company is a distinct legal entity which is entirely separate from its shareholders and directors. A company can sue and be sued, and hold property, in its own name. Limited liability status would limit a dentist's liability in his or her capacity as a shareholder to the amount of capital which he or she agreed to pay up on his or her shares when they were issued. If the shares are fully paid up, the dentist would have no further liability to the company as a shareholder.

Thus, a company will be solely liable for any breaches of contract entered into in its name, unless any of the directors or shareholders had accepted a personal liability to guarantee the company's obligations under a contract. Such contracts would include leases for premises and dental equipment and those with suppliers. Also, the company would be the employer of staff and accordingly liable for claims made by employees whether for redundancy, unfair dismissal, discrimination or otherwise. Any disputes over unpaid fees with associates contracted to the company would be for the company's account.

However, a company is unlikely to offer protection in the area of most significant risk. A patient is likely to sue both the dentist and the company for his clinical negligence. Where the dentist committed a negligent act in the course of his or her employment with the company or as a director, the company would be liable.

The main distinction between a dental partnership and a company is that the other directors would not be jointly and severally liable for the negligence of a fellow director unless they were involved in the negligence; by contrast partners are jointly and severally liable for the negligence of another partner. In practice, this may not be of substantial advantage because, where the company's joint liability for the negligence of a director has a significant impact on its financial position that is likely to affect the value of the company's shares and thus indirectly the other directors and shareholders.

In the light of this a company could be burdened by an extra layer of insurance costs. It is a professional requirement of the General Dental Council that every dentist has membership of a medical defence organisation. However, in addition, the company would need carefully to consider having its own cover. Whilst membership of a medical defence organisation is available to companies, outside investors may have concerns about the discretionary nature of the benefits of medical defence organisations and may insist on the company taking out professional indemnity insurance.

REGULATION OF DENTAL COMPANIES

A company will be regulated by the *Companies Acts* which impose a regime of public accountability and transparency. Unlike partnerships, the company would have to place on public record at Companies House its annual accounts. It also has to file details of its directors, shareholders and new share issues. A company is also obliged to keep proper accounting records and to maintain various statutory registers. If a company fails to comply with these requirements, the directors could be in breach of their statutory duties.

The company would also need to comply with the *Dentists Act* 1984. Under the Government's proposals (as set out in the Department of Health's Consultation Paper August 2002 *Amending the Dentists Act 1984*), a company will be able to carry on the business of dentistry if:

a. its only business is that of dentistry or some ancillary business; and
b. a majority of its directors are registered dentists; and
c. all its operating staff are either registered dentists or dental auxiliaries.

In addition to the reporting requirement under the *Companies Act*, the company would have to submit an annual statement to the Registrar of the GDC detailing its directors, managers and operating staff.

It would be essential that every company institutes appropriate clinical governance controls because its entitlement to carry on the business of dentistry could be withdrawn. The Government proposes that the GDC could remove the power of a company to carry on the business of dentistry in certain limited circumstances, which would include where:

i. the company has been convicted for failing to file its annual statement with the Registrar of the GDC; or
ii. one of its directors has been erased from the Register because of a criminal conviction or a finding of serious professional misconduct; or
iii. one of its operating staff has been erased from the Register following a criminal conviction or a finding of serious professional misconduct and in the opinion of the Professional Conduct Committee the act or omission which led to the erasure was instigated or connived at by a director or a director had or reasonably ought to have had knowledge of the continuance of that act or omission.

Under the *Business Names Act* 1985 the words 'dental' and 'dentistry' are protected so that the Registrar of Companies will not allow a company to be incorporated with one of those words in its title unless a letter of consent has been obtained from the GDC.

LEGAL RESPONSIBILITIES OF DIRECTORS

Even though a company is separate from its directors and can be sued in its own name, there are circumstances in which a director could have personal liability nonetheless. This section lists some of the circumstances in which this could arise.

Directors owe a duty to their company to exercise care, skill and diligence. A director generally only has to show the degree of skill which may be reasonably expected of a person with his or her knowledge and experience. However, if a person is appointed a director because he or she has specialist skills in a particular area of the company's administration, he or she must show the degree of skill of a reasonably competent practitioner in that area of specialisation. Also, a higher duty of care is owed to the company by those who take up specialist appointments. If a director is acquainted with the particular type of business of his company he or she must give the company advantage of his or her knowledge when transacting the company's business. Therefore, any dentist who is appointed a director must give his or her company advantage of his or her knowledge of the business of dentistry which could impose a higher duty of care on that director in clinical matters than on the other non-dentist directors.

Directors are also under a duty to act in what they consider to be the best interests of their company. This requires a director to avoid conflicts between his or her personal interests and those of the company and positions where he or she obtains a personal profit as a result of being a director. Under some partnership arrangements individual dentists are allowed to retain certain professional earnings as personal income. In the corporate context this could amount to a breach of duty. Legal advice should be taken if it is intended to continue such arrangements within a company. There is no solution as simple as a director avoiding his duty by an exclusion of liability clause. Section 310 of the *Companies Act* 1985 provides that a director cannot be exempted from liability for any breach of duty or trust or negligence by any provision appearing in either the company's Articles of Association or any contract with the company. Neither can a company indemnify a director to secure the same result, except in limited circumstances.

If the company were to go into insolvent liquidation, a director could be ordered by the court to pay a contribution to the deficit to creditors where the director knew or should have known that there was no reasonable prospect of the company avoiding going into insolvent liquidation and that director failed to take steps to minimise the loss to the company's creditors (Section 214 of the *Insolvency Act* 1986). Also, on a company's winding up directors could have personal liability for fraudulent trading (Section 213 *Insolvency Act* 1986).

THE CONVERSION PROCESS

A business transfer agreement would be needed to record all the assets being transferred to the new company and that the liabilities of the practice (excluding the dentists' personal liability for tax) would be taken over by the company. Tax advice may dictate how this is implemented. One option would be for the company to issue shares to the practice owners in consideration for the asset transfers, although the total nominal value of the issued shares should not be greater than the value of the assets transferred or otherwise this could be an unlawful issue of shares at a discount under the *Companies Act* 1985.

Where third parties are providing equity finance, they might require the transferring dentist to give warranties either to the company or to themselves confirming a list of matters, such as ownership of assets, details of the staff transferred and that there is no outstanding litigation or pending claims.

It would be important to take legal advice to ensure that legal title to the assets is effectively transferred to the company and that any formalities under the *Companies Act* are complied with. As an example of the latter, the transfer could require shareholders' approval under Section 320 of the *Companies Act* 1985 as an acquisition by the company of non-cash assets from its directors. Your professional adviser could provide you with a checklist of matters which would need addressing before the transfer could take place. Some which could apply are discussed below.

If the surgery premises are mortgaged to a bank, the bank's consent would be necessary to transfer the property to the company and the bank would no doubt require the company to issue new security. If the surgery is leasehold, landlord's consent would probably be required for its assignment to the company. As a condition of such consent the landlord might require individual dentists to act as guarantors of the lease, as indeed the bank might in respect of its facility.

The practice would need to identify key contracts such as with funders, suppliers and providers of dental equipment under hire purchase or lease agreement, and check whether under the contractual terms there is any prohibition on the contract being transferred to the new company. Assuming there is not, the other contracting party's consent would anyway be required for the company to take over all obligations under the contract. For important contracts, this should be obtained through a written novation agreement. The practice should also investigate whether the benefit of equipment warranties and software licences would be transferable

to the new company.

The practice may own copyright in practice literature and in its website. As the owner of the copyright material, the practice would be entitled to stop someone else substantially copying the text without the practice's consent. Legal title to copyright can only be transferred by written agreement between the current owners and the company, the terms of which could be set out in the business transfer agreement.

All staff employed by the practice immediately prior to its transfer to the company should automatically pass to the company under the *Transfer of Undertakings (Protection of Employment) Regulations* 1981 as amended. The company would take over those employees on their current employment terms with continuity of service preserved (except for certain provisions relating to pension schemes). If the Regulations apply there are obligations to provide information and to consult. It should be noted though, that employees have a right to object to their transfer. However, these Regulations do not apply to anyone who is self employed, such as associates or hygienists whose consent would be required for the company to take over their contracts, whether they are in writing or verbal. This should be evidenced in a written novation agreement so that there can be no later dispute that the associate or hygienist is contractually bound to the company.

To ensure a smooth transition, the practice should plan well in advance how it will give the appropriate notifications to patients and (if an NHS practice) to PCTs for new contract numbers. However, under current regulations dental body corporates do not have a contract number but have to nominate principal dentists to take the numbers. It should be noted that under NHS Regulations the principals have responsibility in disciplinary cases for the acts or omissions of their assistants.

STRUCTURE OF THE COMPANY

The company would be incorporated under the *Companies Act* 1985 with a Memorandum of Association setting out its objects and powers and Articles of Association which provides the internal regulation between the company and shareholders. The Articles of Association are effectively a contract between the company and each shareholder as regards his position as a shareholder. The Articles of Association are a public document on display at the Register of Companies and accordingly some practices may wish to keep the Articles to the bare essentials with the detail contained in an agreement signed by all the shareholders and the company. A shareholders agreement has the benefit that it does not need to be disclosed to Companies House but, unlike the Articles of Association, it only becomes binding on a new shareholder who executes a deed agreeing to be bound by the agreement.

What are appropriate internal regulations will vary greatly from practice to practice and legal advice should be taken to ensure that the company ends up with a structure which is appropriate for the particular circumstances and objectives of its owners. However, the Memorandum and Articles of Association will need to restrict the objects to the business of dentistry and ancillary business and to enshrine that the majority of the Board must be registered dentists.

In formulating an appropriate corporate structure, it is likely that a practice will have to take account of at least some of the following issues:

1. Shares can confer rights to vote, dividends and return of capital. However, it is possible to create different classes of shares with all or some of these rights. This offers flexibility when seeking external investors. An investor could, for example, be offered shares with preferential rights to dividends but with voting rights only in exceptional circumstances. Shares can also be redeemable requiring the company to repay the share capital (with or without a premium) to the investor on specified dates. Another alternative might be for an investor to take a separate class of equity shares with enhanced rights to a greater percentage of the proceeds of the sale of the company.
2. Dentist directors should consider the implications if a majority of the shareholders' voting rights are held by non-dentist investors.
3. Dentists need to recognise that there are two tiers for decision-making in a company. The Board of Directors are normally given authority by the Articles of Association to manage the company's business except for decisions which are required by the *Companies Acts* to be taken by the shareholders. Decisions to increase the share capital, authorise the directors to allot shares, change the company's name or to amend the rights attaching to shares or the Articles of Association are vested in the shareholders. Certain of these can be passed by a simple majority of shareholders with voting rights whereas other changes, such as to the Articles of Association, require a Special Resolution passed by 75% of the voting shareholders present in person or by proxy at a shareholders' meeting. It is, therefore, possible that the voting balance at Board and shareholders' meetings could be different. Partly to address this, shareholders' agreements will often contain a list of key decisions which cannot be taken without the approval of a specified majority or the unanimity of the shareholders.
4. The practice will need to consider what happens to the shares of a dentist upon him or her ceasing to practise in the company. There would be various options. One would be for an outgoing dentist shareholder to be obliged to sell his or her shares to the remaining shareholders who would be obliged to purchase those shares. The basis for determining the price of the shares would need to be set out in the Articles of Association or the shareholders agreement. An incoming dentist who is acquiring shares could either be issued with new shares by the company or take a transfer from the existing shareholders or an outgoing dentist.
5. The company should consider whether a dentist should be restricted from transferring his or her shares whilst he or she remains in the company's dental practice.
6. A shareholders agreement could contain restrictive covenants on other business activities of dentist shareholders both whilst they remain with the company and for a certain period after that.
7. The practice owners would need to agree the terms upon which a non dentist investor could sell its shares in the company. The investor may want freedom to sell its shares at any time but the dentist shareholders may wish to restrict the investor to having first to offer the shares to the existing shareholders under pre-emption provisions. The practice should also anticipate the investor wanting to build in an exit route to obtain a return on its share capital. There are many possibilities but one could be an option whereby the investor can call upon the other shareholders on a specified date or event to purchase its shares at market value.

CONCLUSION

The circumstances of dental practices and the objectives of their practice owners will vary enormously. Before embarking on conversion to a company, each practice would have to carry out its own analysis of the pros and cons, and in doing so, would need to understand fully the legal and taxation implications. Thus at an early stage in the planning process, the practice owners should consider taking legal and accountancy advice from practitioners who specialise in the dental field. Just as dental partnership or expense sharing arrangements can become embroiled in disputes where insufficient attention was given to the contractual structure in the first place, so an 'off the shelf' company structure, which has not been tailored to a particular practice, could be storing up major problems for the future.

Addendum

A draft order may be issued by the government between preparation of this article and publication. This may alter some of the government's proposals as outlined here.