



A Guide to Selling Your Dental Practice to a Dental Service Organization



The trend of dental practices being acquired by Dental Service Organizations (“DSOs”) has gained significant momentum in recent years, reshaping the landscape of the dental industry. The following guide is designed to provide practice owners with key insights into the complex process of selling a dental practice to a DSO.

1. Going to Market

For those practice owners who are interested in seeking purchase offers from DSOs, obtaining a calculation of your practice's Earnings Before Interest, Taxation, Depreciation and Amortization (EBITDA) can be very helpful in taking your practice to market. Your practice EBITDA should be calculated by an accountant or broker with experience in conducting this type of analysis, including an understanding of the adjustments that should be made to EBITDA. By way of example, one such adjustment should be made to account for the fair market value compensation you will receive post-closing. A practice valuation based on EBITDA is what DSOs will use to determine the purchase price for your practice. Further DSOs will typically make their purchase offers based on a multiple of EBITDA.

With your EBITDA in hand, you will be better positioned to present your practice for sale to various DSOs, which can create a bidding process among buyers to maximize value.

Once you have received your offer (or ideally, multiple offers), an accountant and legal team will be important resources in negotiating the terms of the offer and deciding which is best suited to your personal and professional goals. Offers typically come in the form of an offer letter or non-binding letter of intent, both of which will outline the general terms of the offer. Once you sign this document to accept the offer, you will likely be barred from exploring potential deals with other buyers during a defined period.

2. Understanding the Offer

In assessing an offer, it is important to note that offers given in today's market typically provide for some of the purchase price to be paid in cash at closing, with the remaining portion of the purchase price to be paid in the form of equity (stock or membership units), a promissory note, and/or earnout payments.

Equity – If your offer provides for a portion of the purchase price to be paid in the form of equity, that equity will likely come in the form of either (A) a small, passive interest in the buyer's parent company ("TopCo equity"), or (B) a more significant, active investment in a new entity owned partially by your practice

entity and partially by the DSO (a "joint venture"). As an owner of TopCo equity, you will likely not receive any payments in connection with that equity until the DSO undergoes a recapitalization event (i.e., a merger, IPO, debt restructuring, etc.). At the closing of such a recapitalization event, you will receive a payment based upon what the DSO receives for its entire business (meaning all the practices it manages). Equity in a joint venture, however, will often entitle you to intermittent distributions of the profits generated by the joint venture over time, but you will not participate in the profits of other practices managed by the DSO. Upon a recapitalization event, you will only

be entitled to the proceeds received by the DSO that are associated with your joint venture. Regardless of the form of equity you are offered, most DSOs will significantly limit your ability to sell or otherwise transfer your equity outside of a recapitalization event.

Promissory Notes – Another popular approach is for DSOs to pay some portion of the purchase price in the form of a promissory note, which allows the buyer to pay you in a series of installments or deferred payments as opposed to a lump-sum. The frequency and duration of payments and interest rates under these promissory notes varies depending on the DSO and terms of the particular deal.

Earnouts – Additionally, some DSOs will offer you a portion of the purchase price in the form of an earnout, which is a contingent payment structure that ties the payment of a specified portion

of the purchase price to the practice achieving certain predetermined performance milestones after the sale. If your offer contains an earnout, it is important to note that these earnout targets can be difficult to achieve, and, even if your practice exceeds the prescribed milestones, you may not receive any earnout payments until the agreed-upon earnout period has expired.

In addition to the purchase price, it is also important to consider other factors when you are assessing your offer, such as the terms of your post-closing employment agreement, the mile radius and length of time of your non-compete, the amount of any retention bonuses offered to your associates and, if you own the property your practice is located on, the proposed terms of a lease or real estate acquisition.

3. Preparing for Due Diligence

Once you have chosen an offer and committed to a particular DSO buyer, the buyer will begin to perform comprehensive financial and legal due diligence on your practice. It is worth noting that the due diligence process is significantly more exhaustive when selling to a DSO as opposed to an associate within your practice or another dentist.

Financial Due Diligence – On the financial side, the buyer's accountants will perform a "quality of earnings" (QoE) analysis, which is a thorough examination of a practice's financial statements to determine the final EBITDA figure that will be used for your practice valuation. A QoE is also used to assess the practice's

financial health and the accuracy and sustainability of its reported earnings. Your practice's accountant will be instrumental in helping you through this process. Buyers typically request historical financial statements, including income statements, balance sheets, and cash flow statements for at least the past three years, as well as detailed breakdowns of revenue, sales data, and operating expenses. The buyer's accountants will look at the practice's accounts receivable, accounts payable, and inventory to assess the efficiency of the practice's working capital management. Corporate tax returns and related tax documents are also requested to assess the practice's tax positions and potential liabilities.

Legal Due Diligence – On the legal side, your attorney will be instrumental in helping you understand the documents and information that will be requested by the buyer's legal due diligence teams. Buyers will want to see all corporate documents of the practice, including articles of incorporation or organization and bylaws, and shareholders' agreements or operating agreements. Buyers will request copies of the licenses held by all dentists and other providers, practice permits, as well as DEA and state registrations for controlled

substances. You will be asked to provide copies of all written contracts, including agreements with patients, employees, independent contractors, vendors, and service providers, and you should be prepared to contact any companies you have loans or equipment leases with, as any debt will likely need to be paid off in full at closing. Legal due diligence also involves providing copies of your insurance policies and employee benefit plans and answering questions about any ongoing or past litigation.

4. Negotiating the Contracts

When selling to a DSO, there will be various agreements for your attorney to negotiate that will define the terms, conditions, and relationships among the parties involved. The specific agreements may vary depending on the structure of the transaction, but you can be sure that your transaction will include some combination or variation of the following documents:

Asset Purchase Agreement (APA)

– Regardless of the structure of your transaction, there will be a purchase agreement that will specify the terms and conditions of the purchase of your practice's non-clinical assets. In an APA, the buyer will purchase specific non-clinical assets and liabilities of the practice, which can include tangible assets (e.g., equipment and inventory) and intangible assets (e.g., contracts, goodwill, and intellectual property). The APA is where the structure of your purchase price will be set forth, and there will be several ancillary documents attached to the APA which will function to transfer the assets (i.e., a Bill of Sale, Assignment and Assumption Agreement, Intellectual Property Assignment Agreement, etc.).

Disclosure Schedules – Regardless of the structure of the transaction, you will be required to make significant representations and warranties in the APA on behalf of the practice. Representations and warranties are statements that provide assurances to the buyer regarding the current state of affairs or the condition of certain aspects of the practice. Any representations and warranties you make are expected to be truthful and accurate at the time they are made, and if a representation or warranty turns out to be untrue and it results in financial losses or damages to the buyer, you may be required to indemnify the buyer for any losses suffered. Many of these representations and warranties will be qualified in the "disclosure schedules," which are attachments to the APA where you will provide additional information about the practice to supplement the representations and warranties. Your attorney will be able to negotiate the language in the APA to ensure that these representations and warranties are reasonable and accurate and that you are making all necessary disclosures.

Employment Agreements – DSOs typically require practice owners to continue working at the practice for several years post-closing, devoting a similar number of clinical hours to the practice as compared with the pre-closing period. Your associates will also need to execute new employment agreements and may elect to hire their own attorney to help them negotiate their contract. Employment agreements in a DSO transaction will also incorporate a non-compete clause, which restricts the employee from competing with the buyer within a defined geographic area and for a specified duration. Any written employment agreements you have with your non-licensed employees will either be assigned to the buyer at closing or will be terminated so that the buyer can immediately hire any transferred employees effective as of the closing date.

Lease Agreement or Assignment
– Regardless of whether you own the practice real estate or lease the location from a third-party landlord, there is typically a leasing component in all DSO transactions. If you own the real estate, there will be a lease between you or your entity that owns the real estate (as landlord) and the DSO (as tenant). If you lease the real estate from a third-party landlord, the buyer will either negotiate a new lease agreement with the landlord or

request an assignment of your existing lease. Such an assignment will often be accompanied by an amendment to modify the lease terms to better suit the buyer's needs. If you lease your location, it is important to have an open line of communication with your landlord early in the sale process to help facilitate the lease assignment.

Joinder, Subscription and LLC Agreements – If you are receiving any equity as part of your deal, the selling dentist or practice will be asked to execute a joinder or subscription agreement to memorialize the terms and conditions of the equity being issued. If TopCo equity is being granted, these agreements will also require you to be bound by the terms and conditions of the shareholders' agreement or operating agreement of the parent company you are receiving equity in. In the event your transaction is structured as a joint venture, you and the buyer will enter into a new operating agreement which will govern the relationship between your practice entity and the buyer entity and specify the rights and responsibilities of the parties after closing. It is important to note that these agreements are long and complex, and their terms and conditions are often non-negotiable. Therefore, your attorney will be an important resource in explaining the restrictions you will be bound by because of your equity ownership.

5. Closing the Transaction

As the transaction progresses, the buyer will complete its due diligence, and the transaction documents will be negotiated until both parties agree they are in final form. The buyer will propose a closing date, which is the day all the assets of the practice will be transferred to the buyer in exchange for payment of the purchase price. A few days prior to the closing date, the buyer's transition team will visit your practice to meet with your staff and set up credit card machines and other accounts in preparation for the transition. On the closing date, you and the buyer will exchange signatures on the transaction documents and the portion of the purchase price that is payable at closing will be delivered to you via wire transfer. Any expenses you have paid in advance of closing that apply to the post-closing period (i.e., real estate taxes, rent payments, monthly service payments, etc.) will be added to the purchase price as an adjustment in your favor. Because the name of your practice is sold to the buyer as part of the practice's intellectual property, a buyer will typically require that you change the name of your entity immediately post-closing so that they can begin using the name themselves.

After the closing date, you will be paid as an employee pursuant to the terms of the employment agreement you signed, and any deferred payments or earnout amounts will be paid as

set forth in the APA. If you received equity, usually you or your practice entity will continue to hold that equity until there is a recapitalization event, or the DSO exercises a repurchase option (if any). You may receive intermittent distributions of the practice's profits in accordance with the operating agreement you negotiated if your transaction was structured as a joint venture. If you are serving as the buyer's landlord pursuant to a lease agreement, you will be paid rent and may be responsible for certain maintenance and repairs under the terms of that lease. In the case of your retirement or termination of your employment with the buyer, you should remain in compliance with any non-compete, non-solicit, and confidentiality covenants in the transaction documents you signed.

Selling to a DSO can be an intimidating process for even the most entrepreneurial practice owner. It is easy to get overwhelmed when you are running a dental practice by day while responding to due diligence requests and reviewing transaction documents by night. Understanding the structure of the transaction and your role in the process is the first step in the right direction, and it is critical to surround yourself with the right team of advisors who will educate you and guide you through the process in a painless and efficient manner.

Assemble your team

It takes an entire team of dental industry professionals to ensure the success and growth of a dental practice no matter where you are in your professional journey. Each advisor serves a unique role in providing proper guidance to dental professionals as they navigate the successes and challenges of practice ownership.

There are six essential roles every dentist and dental specialist should consider when building an advisory team:

- **Accountant** – Understands dental practice economics and ensures accurate financials, tax planning, and practice valuations.
- **Practice Consultant** – Offers operational insight to reduce costs, improve efficiency and growth, and strengthen overall business operations.
- **Attorney** – Protects your interests by providing advocacy and legal guidance on contracts, compliance, risk management, and transition planning.
- **Financial Advisor** – Helps structure personal and practice finances for long-term stability by offering guidance on investments, retirement planning, taxes, etc.
- **Specialty Lender** – Evaluates practice cash flow and growth potential and can often offer one hundred percent financing and working capital in a dental acquisition.
- **Broker** - Assists in valuing and marketing a practice, finding opportunities to acquire and grow, and serves as a resource in helping parties reach a fair deal.

It is crucial that each of these professionals have experience working specifically with dental and dental specialty practices. Often, one trusted advisor will recommend other qualified professionals to help you complete your team.

Taking the time to build this team will provide you with the advice and perspective needed to make informed decisions throughout your career.

Built on relationships,
focused on *results*.



www.mblawfirm.com

973.736.4600
3 Becker Farm Road, Suite 105
Roseland, New Jersey 07068



NATIONAL DENTAL LAW GROUP AT
MANDELBAUM BARRETTpc

William S. Barrett, CEO
3 Becker Farm Road, Suite 105
Roseland, NJ 07068

Tel: 973.736.4600
Fax: 973.325.7467
wbarrett@mblawfirm.com
mblawfirm.com