Due Diligence: A Critical Component of any Transaction

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In our previous article, we detailed the role and importance of the letter of intent (LOI) in establishing a framework for selling a dental practice. Now we will discuss the next step in the transaction – performing due diligence.

Due diligence is the process through which each party evaluates the other party(ies) to determine whether a transaction will be beneficial. It also identifies any business and/or legal risks/obstacles that may need to be addressed prior to closing the proposed transaction and determines whether those risks and obstacles might prevent the closing of the transaction entirely.

DSOs will typically conduct a small amount of financial diligence prior to providing you an offer/LOI. They will request some basic financial information and tax returns to help prepare an initial valuation of your practice and determine the financial terms of the offer. However, following the execution of the LOI a DSO will begin its "financial" and "legal" due diligence process. This process is similar to what you might find in a transaction involving a sale to a third-party dentist or dental practice, however, it will be much more comprehensive when it involves a DSO and its outside advisors (i.e., lawyers and accountants). First, the DSO will provide you with a due diligence request list detailing the DSO's various financial and legal information needs. You will want to share this list with your advisors (i.e., legal counsel, accountant, broker or investment banker) before you begin responding to any requests.

<u>Financial Due Diligence</u>

In general terms, "financial diligence" is conducted by a DSO to gain a better understanding of your practice's financial situation and the practice's potential future performance. Typically, the DSO will engage a third-party accounting firm to review your practice's financial and operation information, including financial statements, tax returns and other related financial documentation to evaluate the practice's assets, liabilities, and ongoing expenses. The accounting firm will also perform a "quality of earnings" (QoE) review to confirm if the DSO's initial valuation of the practice was accurate or if any adjustments are needed. The QoE review will usually run simultaneously with the parties' negotiation of the definitive transaction documents.

Most practice acquisitions by DSOs are valued using a multiple of EBITDA (i.e., earnings before interest, taxes, depreciation and amortization). EBITDA is viewed as a good indicator of a practice's ability to generate cash flow. Also, EBITDA removes the effects of various capital structures and other business conditions that may change after the transaction has closed. When determining EBITDA, the DSO will want to know the practice's "normalized" level of earnings. To do so, the parties will identify non-recurring or extraordinary revenues and expenses, and make corresponding adjustments to EBITDA. If this process determines that the adjusted EBITDA and resulting valuation of your practice is different than what was proposed in the LOI, the DSO will likely adjust

the purchase price that they are willing to pay for the practice. This phase of the transaction is where having an investment banker or broker would be highly beneficial. These professionals can help you to respond to the financial diligence requests and manage the process, and also assist with negotiating the adjustments to EBITDA.

Another benefit of the QoE process is that it allows the buyer to identify any financial/accounting compliance risks/issues so that they can be addressed prior to the transaction's closing. This is another reason we recommend engaging your accountant or a forensic accountant early in the process.

Legal Due Diligence

Simultaneously, a DSO's legal counsel will be conducting "legal" due diligence. This form of due diligence encompasses all other matters related to the historical operations of your practice. Legal diligence permits the DSO to assess whether there are any liabilities and risks associated with your practice that would jeopardize the transaction as a whole or reduce the future profitability of your practice after the closing.

For example, the DSO will want to know about: (i) the practice's historical ownership; (ii) if there has been any litigation, malpractice claims or other types of claims against your practice; (iii) whether your practice has been in compliance with laws (healthcare and non-healthcare related) and if there has been any government enforcement actions related to non-compliance; (iv) the practice's employees and independent contractors; (v) whether the practice has the policies and procedures as required by labor and employment laws and any historical claims of non-compliance with such laws; (v) whether the practice leases or owns the real estate where it has offices; (vi) contracts that the practice is a party to (e.g., payor, employment, consulting, third-party vendors, etc.) and the terms of those contracts; (vii) how the practice has been taxed historically and any historical claims made by taxing authorities of non-payment of taxes; and (viii) the practice's policies and procedures relating to healthcare laws and regulations (e.g., HIPAA policies and compliance) and its compliance with such healthcare laws and regulations.

Depending on the nature and severity of those liabilities/risks, the DSO may walk away from the transaction, reduce the offered purchase price or require that you provide additional post-closing indemnification for such matters. For example, if the practice has a history of non-compliance with HIPAA that has resulted in the dissemination of patient information to unauthorized individuals, the DSO will want an explanation for the non-compliance and if it could be corrected with better administrative support. The DSO will also gauge the likelihood of a claim related to that non-compliance being made against the practice after the closing.

In addition to the DSO's due diligence efforts, this is the time for you to continue doing your own diligence. You should be comfortable that the DSO has a good reputation in the industry, has the resources and ability to grow the practice and has a plan for your relationship with them. You should have extensive conversations with the DSO's management regarding current operations and long-term plans, speak with other

dentists that are affiliated with the DSO and, to the extent equity in the DSO is being offered, request financial information about its operations and review such information with your financial advisors.

Overall, the due diligence process can be time consuming and burdensome, particularly, when you are focused on seeing patients, operating your practice, and trying to maintain some secrecy about the potential transaction around your current employees. It will often require a number of follow-up requests for documentation and conversations with your legal counsel and the DSO's outside advisors. However, if selling your practice to a DSO is your eventual end goal, then being proactive and consulting with your outside advisors early in the process can make the process run smoothly and relieve a considerable amount of stress and burden. At the end of the day, a DSO may be less concerned with a particular matter during due diligence if they see that you have previously identified an issue, sought counsel's advice, and taken steps to fix it.

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