Transitioning to a dental services organization: An emerging trend in orthodontic practice transitions

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Over the last several years, the dental services industry has become increasingly consolidated, creating significant financial opportunities for investors as well as financial and exit opportunities for dentists. This consolidation has been driven in large part by Dental Services Organizations (DSOs) formed by dentists and/or private financial investors (e.g., private equity) through the acquisition of established and profitable practices. This article will explore this emerging trend. (Semin Orthod 2022; 28:23–26) *© 2022 Published by Elsevier Inc.*

What is a DSO/OSO?

A DSO is a business that provides non-clinical administrative services for dental practices.

A DSO can operate in one of two ways. A private equity-backed DSO will acquire a larger, more established practice to serve as a "platform" for its investment or smaller practices to serve as "add-ons" for an already established platform practice. In another DSO model, entrepreneurial dentists will acquire other local practices with the intent of selling to a private financial investor.

As with the medical service industry, which has seen consolidation in a variety of specialty areas over the years (e.g., dermatology, gastroenterology and orthopedics), DSOs are now consolidating the general dental service industry into specialty areas including orthodontics. For example, DSOs are acquiring orthodontic practices to supplement the general dental services already offered by its affiliated practices. Similarly, the number of Orthodontic Service Organizations (OSOs)—dental service organizations solely focused on the specialty of orthodontics—has proliferated.

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The reasons to sell to a DSO or OSO include the anticipation of retirement, creating a need for a succession plan, or a desire to focus on the clinical aspects of dentistry/orthodontics while leaving the administrative aspects to a more business-minded group of individuals. In either of these scenarios, while selling an orthodontic practice to a DSO or OSO can be a smooth and financially lucrative process, doing so presents some risks and/or burdens not found when selling to another dentist or orthodontist.

The process of selling to a DSO or OSO

The process typically begins with negotiating the letter of intent. As part of the letter intent, the DSO/OSO will typically present the practice and its owner(s) with a valuation of the practice. Typically, this valuation will be based on a multiple of the practice's EBITDA (earnings before interest, depreciation, taxes and amortization). The DSO/OSOs valuation, particularly its calculation of the practice's EBITDA, will often be subject to some scrutiny and negotiation on both sides during financial due diligence and the quality of earnings process. In addition to the purchase price, both parties should address the deferment of paying a portion of the purchase price and any conditions that will be placed on such payment. Often in DSO/OSO transactions, a portion of the purchase price will be deferred to help ensure continuity of the practice's operation after the closing to maintain the practice's value. With that in mind, the DSO/OSO will

often condition the payment of the deferred portion of the purchase price on the practice achieving certain financial milestones over specified periods of time, such as defined levels of EBITDA or collections. The issue of whether the purchase price represents the fair market value for the practice also needs to be carefully considered.

After the letter of intent is signed, the DSO/OSO will typically begin its financial and legal due diligence process. This is similar to what you might find in a transaction involving a sale to a third-party dentist or dental practice; however, in most scenarios, a DSO/OSO and its advisors (i.e., lawyers and accountants) will conduct a more comprehensive due diligence process.

In general terms, the purchaser is attempting to uncover any liabilities and risks associated with the practice that would either make the purchaser walk away from the transaction, reduce the purchase price being offered or require that the seller provide additional indemnification for such matters. One example of the risks described above is if the practice has a history of repeated non-compliance with HIPAA resulting in the dissemination of patient information to unauthorized individuals.

A purchaser conducts financial due diligence to better understand the practice's financial situation and its future prospects. Typically, the DSO/OSO will engage a third-party accounting firm to look at the practice's financial statements, tax returns and other related financial documentation to evaluate the practice's assets, liabilities and ongoing expenses and perform a "quality of earnings," which refers to the proportion of income attributable to the core operating activities of a business. This would confirm the practice's initial valuation calculated by the DSO/OSO. Simultaneously, a DSO/OSO's outside legal counsel will be conducting legal due diligence. This form of due diligence encompasses all other matters related to the historical operation of the practice:

(i) The practice's historical ownership.
(ii) Any litigation, malpractice, government actions or other claims against the practice.
(iii) Whether the practice has complied with healthcare and other laws and if there have been any government actions related to non-compliance.
(iv) The universe of the practice's employees and independent contractors, whether the practice has certain 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 for its office locations.
(vi) Whether there are 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 prior or current claims made by taxing authorities of non-payment of taxes.
(viii) The practice's policies, procedures and compliance with healthcare laws and regulations (e.g., HIPAA policies and compliance).

As the DSO/OSO is conducting its due diligence, you should do some digging as well. You should be comfortable that the DSO/OSO 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. It's recommended that you have extensive conversations with the DSO/OSO's management team regarding current operations and long-term plans, speak with other dentists/orthodontists that are affiliated with the DSO/OSO and, to the extent equity in the DSO/OSO is being offered in the form of "rollover equity" (essentially an equity interest in the DSO itself) or otherwise, request financial information about its operations and review such information with your financial and legal advisors.

Overall, you should expect that the due diligence process will be time-consuming and potentially burdensome, particularly, when you are trying to continue to see patients, operate the practice and prevent employees from finding out about the potential transaction. It will often require a number of follow-up requests for documentation and conversations with you and the practice's outside advisors.

How the deal will be structured

The typical legal structure will be a sale of the practice's non-clinical assets (e.g., equipment,

office furniture, equipment and real estate leases and other non-clinical contracts) to the DSO/OSO and a sale of the practice's clinical assets to a captive professional entity that is affiliated with the DSO/OSO. In addition, at closing, the practice's non-clinical employees would be transferred to the DSO/OSO and all remaining clinical employees (i.e., dental assistants, hygienists) would be transferred to the captive professional entity. In addition, following the closing, the non-clinical assets and non-clinical staff would be leased back to the DSO/OSO's captive professional entity pursuant to an administrative services agreement. Also following the closing, the practice's professional entity would cease operations and the owner(s) would wind up and dissolve the entity in due course. The prohibition against the corporate practice of dentistry, fee-splitting and other applicable fraud and abuse laws must be carefully considered by legal counsel.

In some instances, the DSO/OSO might determine during due diligence that the practice has certain licenses, permits and/or contracts that cannot either be assigned/transferred to the DSO/OSO or its captive professional entity, as applicable, or that cannot be obtained by the DSO/OSO or its captive professional entity on their own behalf following the closing. In those scenarios, the DSO/OSO may need to structure the transaction so that a "friendly" dentist/orthodontist purchases 100% of the equity or stock of the practice's professional entity from its owners rather than transfer the clinical assets to its captive professional entity. The DSO/OSO would then enter into an administrative services agreement with the practice at closing. The fee paid by the professional entity to the DSO must be fair market value for bona fide services rendered so as to comply with applicable fraud and abuse laws.

Additionally, it is important to analyze how the proceeds received by the owner(s) in the sale will be taxed so that the transaction can be structured in the most tax-efficient manner (e.g., proceeds taxed at the capital gains rate rather than the ordinary income rate,). This will be particularly important if the DSO/OSO is offering the owner (s) rollover equity in the DSO/OSO itself or in any parent holding company of the DSO/OSO. This way, the selling dentist is incentivized to participate in the post-closing success and growth of the practice. You should seek advice from your accountant and legal advisor (particularly those that specialize in tax law) as early in the process as possible. Often, both the buyer's and seller's tax counsel will need to confer to discuss structuring.

Regardless of how the transaction is structured, the DSO/OSO will, in connection with the purchase agreement, ask the sellers to make representations regarding the historical operations of the practice and provide indemnification for a variety of items:

(i) Breaches of the representations and warranties.
(ii) Breaches of any covenants provided in the purchase agreement. Liabilities that the DSO/OSO identifies during the due diligence process that are of considerable concern (e.g., prior non-compliance with healthcare laws or regulations).
(iii) Matters that relate to the pre-closing operation of the practice.

Post-sale considerations

After the sale closes, the DSO will want to ensure, to the extent possible, that the practice will be successful. Since a smooth transfer of patient and staff relationships often requires a long transition period, most DSOs expect relatively long-term employment agreements with the sellers. Typically, the seller is required to enter into a three- to five-year employment contract after closing. The high-level matters covered by any employment agreement include compensation (e.g., a flat base salary or a salary based on a percentage of collections, which is most common) and termination rights (i.e., what constitutes a "cause" termination and, if either party may terminate without cause, how much notice is required). Special consideration should be given to termination rights if rollover equity is involved, as oftentimes, if employment is terminated for cause, that will result in the forfeiture of any unvested, and sometimes any vested, equity. Finally, any employment agreement would contain non-competition and non-solicitation clauses, which would, in general terms, prohibit the practice of dentistry/orthodontics within a

defined geographic area, as well as activities that are related to the DSO/OSO's operations. You should discuss the scope of the geographic area and time period that these covenants cover with your attorney who can advise on their practicality and enforceability. Over time, the DSO will implement new processes to make the practice more successful.

If you are interested in selling your practice to a DSO/OSO (or even a third-party dentist/practice), then being proactive can make the process run smoothly and relieve a considerable amount of stress and burden. As such, you should begin organizing as soon as possible by implementing robust record-keeping practices and consulting with outside advisors to help prepare the practice for a sale. Legal counsel can help identify potential areas that a purchaser might find problematic or of heightened concern and devise ways to mitigate them.