Red Flags When Selling Your Urgent Care Practice

Urgent Message: Offers to buy urgent care centers typically follow due diligence processes, and the assets are valued within predictable market ranges. Offers to purchase a center that fall outside usual and customary parameters should be evaluated with scrutiny and skepticism.

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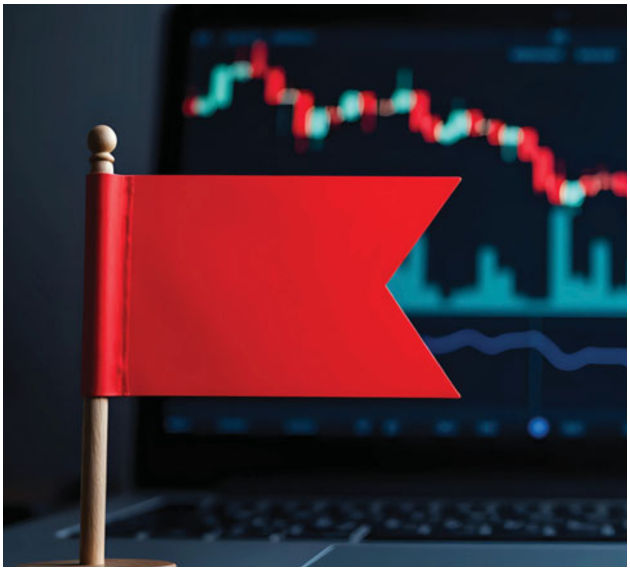

Selling your urgent care business may be an opportunity to reap a return on your investment. However, there could be buyers looking to take advantage of your enthusiasm and urge you to sign an unsolicited deal that's no deal for you.

What Is a Term Sheet?

Urgent care owners may be approached by a potential buyer with a term sheet. Also called a letter of intent or memorandum of understanding, this document states certain terms of a transaction agreed upon in principle between parties. It is usually negotiated and signed at the start of a transaction. Term sheets evidence serious intent but generally aren't legally binding.[1,2] Although, some term sheets have legally binding provisions, such as confidentiality agreements.[3] Some of the common components of term sheets are:

- A valuation of the business establishing the net worth of the company prior to new investment
- Liquidation preference of how the seller will get paid in the event of a future sale of the company
- Provisions for anti-dilution protecting an investor's ownership percentage should the company issue new shares in the future
- A "drag-along" provision limiting shareholders' ability to block a future sale of the company[4,5]

Specific details of the term sheet are affected by whether the transaction is an asset sale or equity sale.

Asset Sale

In an asset sale, the buyer selects the assets they want to purchase and leaves the rest of the business with the seller. Assets purchased by the buyer may include real estate, equipment, supplies, trademarks, patient lists, and other intellectual property. *All liabilities remain with the seller* unless they're assumed by the buyer.[6] After an asset sale, the existing business entity survives without the transferred assets.[7,8]

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Liabilities can also be part of an asset sale, however, they won't be assumed by the buyer unless so stated in the sales agreement.[9,10] The most common liabilities assumed by buyers are the lease on the physical space and service contracts on equipment. Debt and other obligations typically remain with the seller.

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However, asset sales can mean higher taxation for sellers compared to equity sales when the assets are sold for more than their depreciated value.[11,12] Asset sales also entail extensive effort in negotiating the value of individual assets and liabilities. As a result, these sales can frequently be more time-consuming and resource-intensive than an equity sale.

In urgent care, an "asset sale" typically occurs when an established urgent care operator—that has insurance contracts—wants to acquire a physical facility, its team members, and patients. The seller typically retains and continues to collect on the accounts receivable, and the seller will be responsible for paying off any debts of the business. In addition, the seller will be liable for any litigation against the business.

Sellers should bear the following in mind when contemplating an asset sale:

- Clearly identify the assets in the transaction and create a comprehensive list.
- Determine the allocation of the purchase price among different assets, and clearly defined categories of tangible and intangible assets, which helps with tax planning and financial reporting.
- Be aware of any conditions to address before the deal can move forward, such as obtaining necessary permits or licenses.
- Review any non-compete and confidentiality agreements that keep the seller from competing with the buyer in the future. The terms and limitations should be succinctly defined to ensure their enforceability.

Equity Sale

In an equity sale, the current owners sell *all* of the outstanding shares or interests of the business to the buyer. The buyer acquires ownership of the *entire* business entity, including all its assets, known and unknown liabilities, contracts, and obligations. With an equity sale, the existing business continues to operate—just under new ownership and management.[13,14]

There are several advantages to an equity sale. First, this type of sale almost always provides more favorable tax treatments for sellers compared to asset sales. In contrast to asset sales (where the sale of certain assets can result in the recognition of ordinary income), equity sales let sellers (who own their equity for more than a year) enjoy long-term capital gains tax treatment on all proceeds received from the sale of their equity. Another benefit of this type of sale is that it lends itself to a more straightforward transaction structure for sellers than asset sales.

In an asset sale, each asset and liability must be identified, negotiated, and valued. However, in an equity sale, the process entails valuing the entire operation as an ongoing business. Equity sales provide for a more comprehensive and precise determination of company value. Intangible assets like the urgent care's customer base, goodwill, and brand recognition are converted into profits and losses that are reflected in the financials. Equity sales offer a streamlined approach to valuation, which can mean closing the sale more quickly and with fewer obstacles.[11]

An equity sale provides sellers with a "clean break" from the business. This is because the buyer assumes all assets and liabilities, which permits the seller to fully disengage after the sale. However, sellers will usually realize a lower sale price on an equity sale due to the buyer's foregone tax benefits.[11]

Unlike an asset sale—in which the buyer can enjoy a "stepped-up" tax basis on the acquired assets (allowing buyers to depreciate the asset and generate tax savings)—equity sales don't have this tax advantage for the buyer. As a result, the buyer assumes the business's existing tax basis in the assets and only gets the basis in the purchased equity that can't be depreciated. In this case, buyers often negotiate for a lower purchase price to compensate for any foregone tax benefits.[11]

There also may be legal restrictions that prevent certain buyers from owning or controlling the business. For instance, corporate practice of medicine laws at the state level may require that the practice be owned by a physician.

Finally, in an equity sale, the buyer assumes the risk of all unknown or undisclosed liabilities that come with the business, such as future taxes or pending malpractice litigation that wasn't raised or known during due diligence. With this, buyers will ask sellers to put some of the sales price in escrow or provide further assurances (eg, indemnities or warranties) to shield against the risks of these potential unknown liabilities.

In an equity transaction, the seller would typically receive cash in exchange for their asset. Otherwise, if a seller receives illiquid stock in a "consolidation entity," the seller may not be "paid" until the acquiring entity subsequently sells. In effect, this is not a sale of the practice so much as giving someone else the right to sell the practice as part of a larger portfolio. Not only is there a risk that a subsequent sale will never occur, or will not occur at an expected future valuation, but it also prevents the seller from transacting with anyone else during the contract term.

Other Red Flag Clauses to Scrutinize Regardless of the Type of Sale

Extraordinary Valuation

A buyer may describe a future in which equity in a consolidation portfolio subsequently sells for an irresistibly high multiple of revenue.

Urgent care chains have never been valued as a multiple of revenue, but rather as a multiple of EBITDA. The types of companies that trade on a multiple of revenue—think early Uber, Amazon and Tesla—are capital-intensive, focused on quickly proving demand, with a plan to become profitable once operations scale. These can be described as "frothy" businesses, characterized by speculative fervor, investor overconfidence, and a general disregard for traditional valuation metrics.

These "frothy" characteristics do not describe established local businesses like urgent care.

Choice of Law

The governing law clauses stipulate which state's laws will govern the contract and where any disputes must be heard. An unfavorable jurisdiction can create issues in litigation and add to legal expenses. Plus, it could mean biased outcomes if the jurisdiction is more favorable to the other party than to you. Favorable choice of law terms can decrease risks and ensure fairness in lawsuits. So, if you're buying an urgent care in Florida, for example, but the seller is in New Jersey and advocates use of that state's law, it can be less favorable for you.

Unbalanced Clauses

Unbalanced clauses can dramatically shift the rights and obligations in favor of one party, causing an unfair contractual relationship. For example, a seller may be expected to continue running the practice and servicing the debt of the business, while turning over free cash flow and covering the buyer's working capital shortfalls. If the seller receives equity in a portfolio of other practices, this could result in the seller of one practice financing the shortfalls of other practices in the portfolio.

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Should your revenue fall, such would affect your share of proceeds from the portfolio sale. You could be left with little to nothing after all your debts are paid. Yet, the dealmaker will profit by taking a significant share of the proceeds if the portfolio sells.

Integration Clauses

This term states that the contract represents the full and final agreement between the parties. All previous emails and conversations that are not formally written into the contract are unenforceable. If the buyer verbally promised that your stock in a consolidation portfolio will "sell by a multiple of 7- or 8-times earnings," but that promise is not written into the final purchase agreement, the integration clause means you cannot sue them if you later find out it wasn't true.

Unilateral Amendments

Contracts are fundamentally mutual agreements but if the contract permits one party to change terms without the other party's notice or consent, the contract becomes unpredictable and potentially worthless for the party without the power to amend. The presence of unilateral agreements mean there is no certainty that the terms agreed upon at closing will remain in effect.

Penalty Clauses and Restrictive Covenants

Contracts frequently have penalty clauses for breaches, so make certain they are reasonable. The contract may also restrict the seller's future activities, such as noncompetition and nonsolicitation agreements that prohibit the seller from working for a competitor within a geographic region or with former employees or business associates for a specified period of time.

Dispute Resolution Method

The sales contract should specify the way in which disputes will be resolved, such as via mediation or arbitration.

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Termination Clause

The contract should have a term that clearly states how either party can terminate the agreement, including the circumstances and ramifications.

Holdbacks

A portion of the agreed-upon purchase price may be withheld from the seller at the closing of the transaction. This amount is typically placed in an escrow account managed by a neutral third party and is held for a predetermined period, often ranging from 12 to 24 months. The primary purpose of a holdback is to cover any unexpected debts or legal claims, damages incurred by the buyer if claims about the condition of the business prove to be false, or working capital shortfalls owed to the buyer. Once the holdback period expires, and assuming no claims have been made, the remaining funds are released to the seller.

Earn Outs

A portion of the purchase price may be contingent on the future performance of the acquired business. Payments are made to the seller only if the company achieves certain previously agreed upon financial or operational milestones. Earn-outs can last for a few months to several years. Longer earn-out periods delay payment and increase risk to the seller if the business doesn't perform according to the buyer's expectations, which means the seller may not be paid the initially agreed-upon price.

Make certain that the transaction agreement is clear and specific. If the contract doesn't clearly detail items like payment amounts and deadlines, be wary. Likewise, if you feel that terms are ambiguous or unspecific, seek changes when negotiating. Finally, if the contract appears to be a "one-size-fits-all" template that lacks any details about your specific business transaction, it's another red flag.[15,16] You may have to walk away from the deal if the seller won't accommodate your concerns.

Conclusion

When faced with a term sheet or sales proposition, urgent care owners should examine the document carefully and with the aid of legal counsel. An attorney will help you understand the terms and conditions and seek clarification for anything that appears to be unclear or questionable. A sales contract should protect both the buyer and the seller, and as such, it should be clear, respectful, and fair. Be wary of the red flags mentioned above, especially with unsolicited offers with valuations that seem too good to be true. ■

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