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# To sell or not to sell: Contractual considerations in the sale of physical therapy practices

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Consolidation of physical therapy practices by national or regional buyers has been occurring at a strong pace and is expected to continue in the near-term. Many independent physical therapy practices have been or will be approached by national or regional buyers to discuss a potential transaction. Practice owners may also test the waters of selling by retaining an investment advisor or approaching potential acquirors directly, to assess the interest of acquirors in pursuing a strategic transaction.

Strategic transactions like these are unique to each case, but all parties benefit from a firm grasp of the process, considerations and factors that shape each transaction. As independent physical therapy practice owners may not regularly handle transactions like the sale of their practice, this article summarizes the major components of the key agreements that are entered into in such a transaction and discusses some of the considerations that affect each element.

## *Key Agreements in a Transaction*

There are typically two major agreements or categories of agreements in a purchase and sale transaction. The purchase agreement lays out the specific elements of the transaction and the obligations of each party. The employment agreements specify the terms under which each owner will continue to be employed after the completion of the sale. Each agreement is negotiated by the practice and its owners, the buyer and their respective advisors.

### *Purchase agreement*

The purchase agreement memorializes:

- The structure or form of the transaction
- The representations and warranties made by the physical therapy practice and its owners to the acquiror
- The terms of the escrow arrangement (if any)
- The documents to be delivered by the respective parties
- The conditions precedent to the obligation of each party to close the transaction
- The non-compete covenant and other restrictive covenants agreed to by the owners of the physical therapy practice
- The indemnification obligations of the owners of the physical therapy practice to the acquiror
- Other possible matters

Breaking down some of those items:

**Form of transaction.** Typically, a strategic transaction between an acquiror and a physical therapy practice will involve the purchase of substantially all the assets of the practice or the purchase by the acquiror of all the outstanding equity – shares of stock, membership interests, etc. – of the practice. The particular form of transaction depends on the tax status of the practice to be acquired, the ownership structure of the practice to be acquired, whether the acquiror has payor contracts and provider numbers of its own or needs these items from the target practice, and other factors.

In the alternative, or in conjunction with a purchase and sale of substantially all the assets of the group or a purchase and sale of equity, an acquiror may purchase, and the owners of the practice may sell, all of the

professional goodwill held by the owners. Such a structure presupposes that all or substantially all of the goodwill associated with the practice is held by the owners and not by the practice itself. The question of whether the goodwill associated with the practice is owned by the practice or by the owners is a somewhat complicated one, and the answer to the question depends on a factual analysis, including a determination as to whether the owners are subject to non-compete covenants under which they have essentially transferred their professional goodwill to the practice because the owners do not have the legal right to compete with the practice.

**Due diligence.** Regardless of the type of transaction agreed upon by the parties, a buyer will always conduct a very thorough due diligence review of the physical therapy practice. Such a due diligence review will usually include:

- An analysis of the billing and coding practices of the group
- A review of the financial statements of the group
- Possibly a review of past ownership of the group and a determination as to whether past owners were bought out and no longer own an interest in the practice
- A review of the practices of the group with respect to classifying providers as employees versus independent contractors
- A review of the provider contracts and other contracts to which the practice is a party
- Numerous other potential issues

The due diligence process can be daunting, and it is very helpful for the physical therapy practice to have well-maintained records to comply with the many requests for documents and information that will be made by the potential acquiror and its accountants, attorneys and other advisors. The practice is often assisted in the due diligence process by its investment advisor and/or its attorneys. The due diligence process will be mirrored by a great number of representations and warranties that will be made by the owners of the physical therapy practice to the acquiror in the purchase agreement, and for which the owners of the practice will be financially responsible under the indemnification provisions in the purchase agreement.

Occasionally, problems with the group will surface during the due diligence process where the acquiror will decide not to proceed with the transaction. The potential acquiror will have the right to do so, regardless of whether a purchase agreement has been signed by the parties or as is more common, is intended to be signed later in the process.

**Escrow.** Acquirors in strategic transactions with physical therapy practices will often require that a portion of the purchase price – typically 5% to 10% – be placed into escrow. The escrowed funds are then available if there is an indemnification claim by the acquiror, as discussed below. The escrowed amount typically is not a limit on the potential liability of the sellers under the indemnification provisions.

All or a portion of the escrowed funds will be paid to the acquiror in the event of an indemnification claim only if there is an agreement on the part of the sellers that they are responsible to indemnify the acquiror. In the event of a disagreement among the parties, the disagreement will be resolved by negotiation between the parties or by a judicial process if necessary. Funds are typically held in escrow for a period of one to three years. At the conclusion of the escrow period, funds that have not been returned to the acquiror on account of an indemnification claim are disbursed to the owners as an additional purchase price.

**Covenant not to compete.** The purchase agreement will include a covenant not to compete, where each of the owners of the practice agree not to compete with the acquiror. That includes the practice of physical therapy or the ownership or management of a physical therapy practice for a period of time following the close of the transaction. The time period is typically five years and specific terms of the non-compete covenant are negotiated by the parties. Those terms will include a covenant not to compete with the acquired practice in its service area, and may include obligations not to compete with the acquiror in other geographic regions in which it operates. The specific scope of the non-compete covenant is obviously an important part of the transaction terms, because if an owner of the practice does not remain as an employee of the acquiror throughout the term of the non-compete, he or she may have to relocate to be employed in the field of physical therapy.

The employment agreements between the acquiror and the owners of the practice will also include a non-compete covenant that will be for a different time period and may well be somewhat different in its particulars than the purchase agreement non-compete covenant.

**Indemnification.** The purchase agreement will include indemnification provisions under which the owners of the practice agree to be financially responsible for any pre-closing obligations or liabilities of the practice that are not assumed by the acquiror. The theory behind the indemnification provisions is that the acquiror is paying a purchase price for the practice which assumes that there are no material unknown or undisclosed liabilities or obligations of the practice. If there in fact turn out to be such liabilities or obligations – an occurrence that is very unlikely, but nevertheless possible – then the acquiror has in effect overpaid for the practice, and a portion of the purchase price should be returned to the acquiror via the indemnification provisions. The indemnification provisions typically include a “basket” that constitutes a threshold or a deductible before the indemnification obligations apply, as well as a cap that limits the dollar amount for which the owners are responsible. There are several variations with respect to the basket and the cap that serve to limit or expand the potential liability of the owners.

## *Employment Agreements*

The employment agreements constitute one of the two categories of major transaction documents that are negotiated by the practice and the acquiror and their respective advisors.

The employment agreements memorialize the terms under which the physical therapist owners of the acquired practice – and perhaps other key personnel such as the manager of the practice – will provide services during a period of time following the closing of the acquisition. These services could include the financial terms under which the employees will be compensated during the term of the agreement, the grounds on which an employment agreement can be terminated prior to the end of the scheduled term, the non-compete covenant and certain other matters.

**Degree of control over practice.** The employment agreements with physical therapists will always provide that the physical therapist maintains control over physical therapy decision-making. The concept that a physical therapist must be the decision-maker with respect to physical therapy decision-making represents the core of the corporate practice of physical therapy doctrine.

**Term of employment.** From the point of view of the buyer, it is essential to the economics of the transaction that the physical therapists who formerly owned the practice remain as employees for a stated period of time, but only if

they were practitioners. The buyer may also lock in other key employees, such as non-physical therapist owners and the manager(s) of the practice. During the term of employment, the employee typically will provide services for less of a salary than the employee has historically been receiving, as long as the employee is also a selling owner. Acquirors of physical therapy practices will typically require that each such employee enter into an employment agreement with a stated term of two-to-five years. To the extent that the term of employment exceeds the length of time that certain employees intend to continue to work, including employees who may have indicated to the practice prior to the transaction a plan to retire as of a certain date, it may be possible to negotiate a reduced term of employment for employees.

**Compensation.** The compensation model used by acquirors of physical therapy practices is typically that the employee is paid a fixed salary, perhaps with the potential to earn a bonus if certain benchmarks are achieved.

**Termination of employment agreement.** The employment agreements will include provisions permitting the acquiror to terminate employment prior to the stated term for cause, the terms of which should be carefully negotiated. The definition of “cause” will include material breaches of the employment agreement by the employee, with a right of the employee to cure the applicable cause within a stated period of time to avoid termination of the agreement.

Employees should also negotiate the right to terminate the employment agreement for “good reason,” which is generally defined as a material breach of the agreement by the employer, with a right of the employer to cure the applicable cause within a stated period of time to avoid termination of the employment agreement.

**Covenant not to compete.** This non-compete covenant is in addition to, and separate from, the non-compete covenant contained in the purchase agreement. The employment agreements will include a covenant not to compete, under which the employee agrees not to compete with the acquiror while employed by the practice and for a period of time, typically two years, following termination of employment. The two non-compete covenants will be different in terms of time period and may be different in their geographic scope. The specific terms of the employment agreement non-compete covenant will be negotiated by the parties. Those terms will likely include a covenant not to compete with the acquired practice in its service area and may also include obligations not to compete with the acquiror in other geographic regions in which it operates.

The decision to sell a physical therapy practice is obviously a momentous one. The sellers should have experienced transactional healthcare counsel to guide them in connection with the legal issues arising in the purchase and sale. If you have questions about selling your physical therapy practice or any healthcare business, please reach out to me at [jmh@saxtonstump.com](mailto:jmh@saxtonstump.com) or (484) 328-8505.

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