

HEALTHCARE PRIVATE EQUITY ASSOCIATION 101: LEGAL CONSIDERATIONS



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Lindsey represents private and public companies and private equity sponsors in connection with a wide range of corporate and transactional matters. Her practice focuses on mergers and acquisitions, divestitures, corporate carve-outs, leveraged buy-outs, joint ventures, debt and equity investments, equity restructurings and recapitalizations. She also advises clients regularly on general corporate and corporate governance matters.

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Diego focuses his practice on complex domestic and cross-border business transactions, with an emphasis on the representation of multinational companies and private equity firms in connection with mergers and acquisitions (M&A), divestitures, investments and other commercial activities. He also advises both publicly-traded and privately-held companies (including portfolio companies of private equity firms) on matters relating to corporate finance, venture capital and growth equity investments, recapitalizations, joint ventures, securities offerings, corporate governance and general corporate advice. Diego is also a frequent speaker and contributor to legal publications on M&A-related matters.

STRUCTURING TRANSACTIONS AND ANATOMY OF A PURCHASE AGREEMENT

BASIC TYPES OF TRANSACTIONS

1. Asset Purchase

- Buyer acquires assets and assumes specified liabilities of the Target

2. Equity Purchase (stock, membership interest, etc.)

- Buyer acquires equity of the Target directly from its equityholders

3. Merger

- Target merges with Buyer (or one of its subsidiaries) under state law
- Equityholders of the Target receive consideration (cash and/or stock/equity of Buyer)

DRIVERS OF TRANSACTION STRUCTURE

- Ease of execution
- Allocation of risk
- Tax planning/strategy
- ***Structure is generally a letter of intent stage issue***

DETERMINING STRUCTURE (ASSET PURCHASE)

- **Why an asset transaction?**

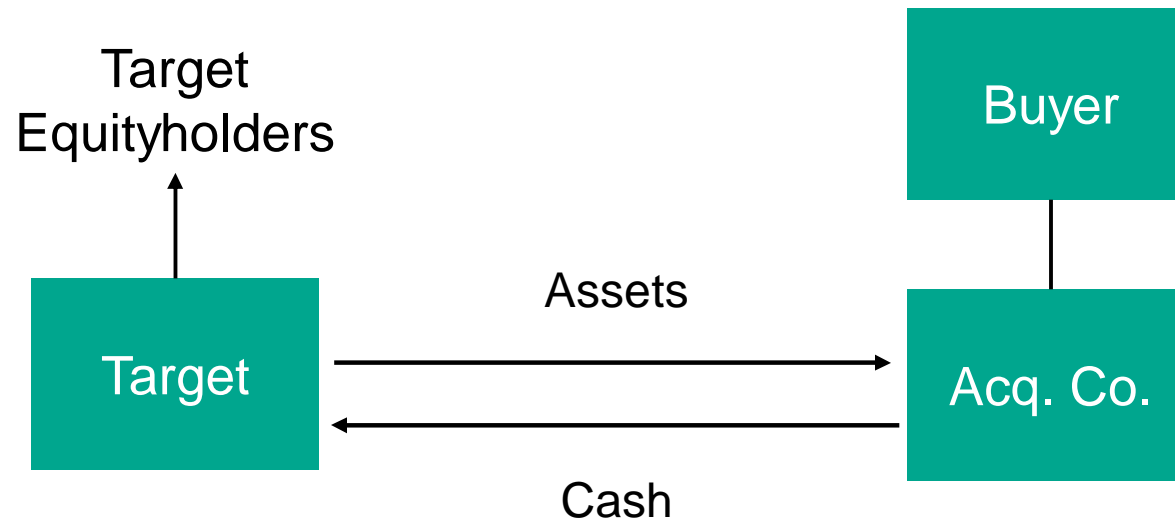
- Allows Buyer to pick and choose assets and liabilities
 - Often used in a transaction in which you are splitting up a business
 - Also used by Buyer to avoid certain historic entity-level liabilities (e.g., environmental, regulatory, taxes)
 - Can help address Buyer's concern with Seller's ability to satisfy its indemnity obligations
- Only requires equityholders of Seller that own a majority of the outstanding equity to approve under many states' laws
 - 66-2/3% in some states
 - Check charter and Stockholders Agreement to confirm a higher percentage is not required
- Tax benefit from basis step-up in assets often adds value for Buyer in the form of a future tax-shield

DETERMINING STRUCTURE (ASSET PURCHASE)

- **Why not an asset transaction?**

- Leaves Seller with historic liabilities
- Can result in adverse tax consequences for Seller
 - Gain on some assets (such as cash method A/R or recapture income) subject to ordinary income tax rates
 - C corporation double tax
 - Potential transfer taxes
- Each asset has to be transferred vs. just transferring the equity of Target
 - Contracts (requirements for third party consents), Vehicle titles, Real property title, Permits, Intellectual Property, etc.
- Not a preferred outcome for a Private Equity Seller
 - Results in the retention of liabilities that the Seller must continue to address and potential tax inefficiencies if sale of a C corp target

ASSET PURCHASE



Results

(same tax results for equity acquisition of 100% of LLC/partnership or S corporation with 338(h)(10)/336(e) election)

- Buyer limits liabilities assumed
- Gain recognized by Target
- Second level of tax - capital gain to Target Equityholders if Target is a C corporation
- Buyer obtains a stepped up basis in assets

Comments

- Parties will generally need to agree to a purchase price allocation (can impact character of gain/loss to Seller and nature of deductions to Buyer)
- LBO Perspective: May want debt inside Acq. Co. for state tax or financing reasons
- Transfer of assets by assignment

DETERMINING STRUCTURE (EQUITY PURCHASE)

- **Why an equity transaction?**

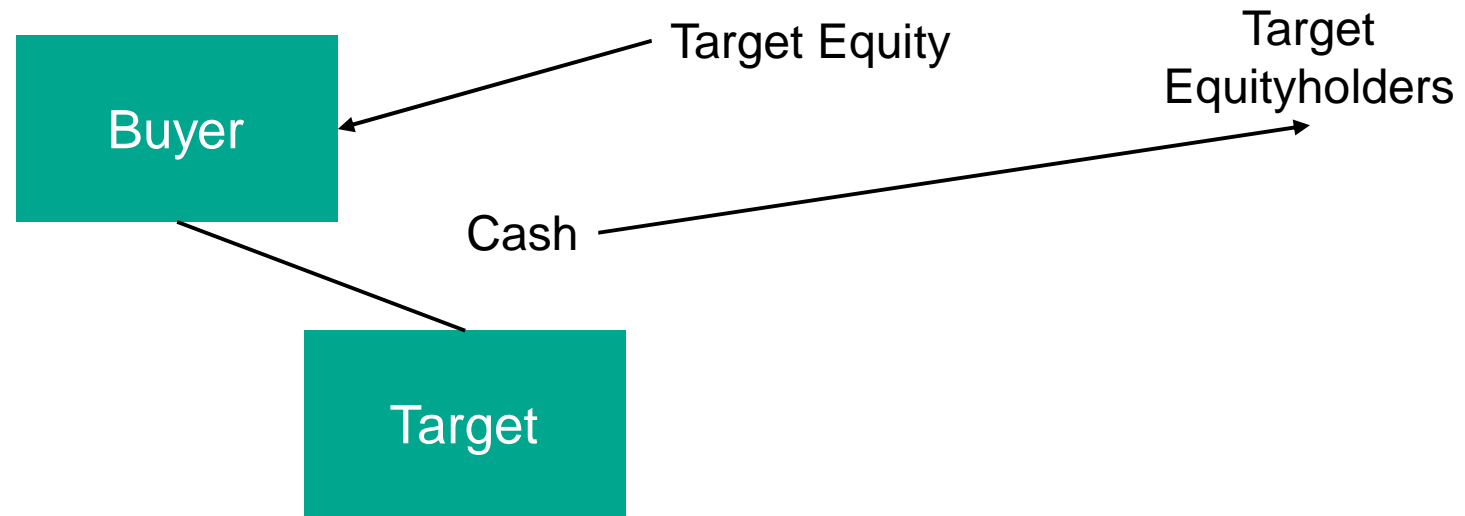
- Cleanest break for Seller
- Simpler to transfer the business in many cases
- Usually only results in one level of tax to Seller and generally at capital gains tax rates
- May facilitate favorable tax attributes of Target transferring to Buyer (subject to certain limitations)

DETERMINING STRUCTURE (EQUITY PURCHASE)

- **Why not an equity transaction?**

- Buyer acquires the entire history of the Target (rather than specified liabilities)
- Not a preferred structure if Target has significant potential contingent (or just unknown) liabilities
- May be too many equityholders to make it workable (can get similar result with merger)
- Loss of basis step up for C corp targets

EQUITY PURCHASE



Results

- Subject to indemnification, all liabilities are retained by Target and become Buyer's responsibility
- Generally capital gain to Target stockholders
- Carryover basis in assets (unless Target is an LLC/Partnership)
- Target tax attributes retained (subject to limitation)

Comments

- Use for C corp. target
- Forgoes goodwill amortization benefit (unless target is an LLC/Partnership)
- LBO Perspective: May want debt inside Target for state tax or financing reasons

DETERMINING STRUCTURE (MERGER)

- **Why a merger?**

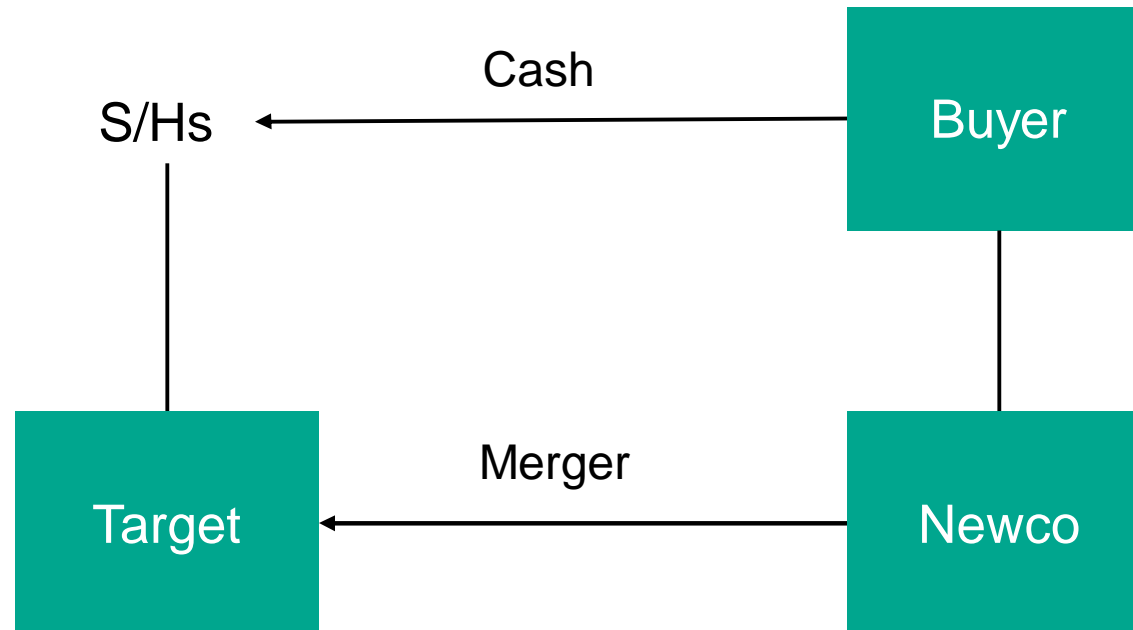
- Common transaction structure for acquiring a public company or a private company with many equityholders
- Allows buyer to acquire equity without having to orchestrate the tendering of equity by many equityholders, subject to appraisal (dissenters) rights
- Good structure for a Private Equity Seller because typically no Private Equity Fund entities are a party to the transaction other than the operating company or holding company (a way of trying to insulate post closing risk)
- Can help solve potential “holdout” issues and helps put the debt at the correct level
- Depending on consideration mix (equity vs. cash), can be structured to be all or partially tax-free to target equityholders for C corp targets

DETERMINING STRUCTURE (MERGER)

- **Why not a merger?**

- Complexity of complying with state laws and sometimes SEC and exchange rules and regulations
- Appraisal/Dissenters rights may be exercised by stockholders after the closing
- Similar issues as equity transactions
 - But in a merger not all stockholders are required to sign the main acquisition agreement
 - However, if the Buyer is looking for indemnification protection or noncompetes from equityholders, you will still need those equityholders to execute the merger agreement

STOCK SALE - REVERSE SUBSIDIARY MERGER



Comments:

- Transitory Newco merges into Target under state law
- Buyer's stock in Newco converted into Target stock
- No asset transfer

EQUITY CONSIDERATION

- Private Equity Fund buyers often want the Seller to have “skin in the game”
 - Management, founders, and other key employees to have equity ownership in the newly acquired company post- closing
- Solution = create equity ownership for management
- Equity ownership vehicles for incentivizing management
 - Rollover Equity
 - Equity Incentive Programs

ROLLOVERS

- Sellers often receive Buyer equity to ensure “skin in the game” and incentive to capture future upside
- Typically structured as a contribution of target equity into a parent entity controlled by Buyer
- Rollover equity can be structured as subordinate or pari passu with Buyer’s equity
- Requires negotiation of go-forward agreements (e.g. stockholders’ agreement), which does add complexity and potentially additional time

EQUITY INCENTIVE PROGRAMS

- Following closing, in addition to rollover equity, incentive based equity programs can be used by the newly acquired company
- Types of Equity Incentives
 - Stock Options (ISOs v. NQSOs)
 - Restricted Stock
 - Profits Interests
 - Other Equity-Linked alternatives
- Align interests of key employees with private equity fund (i.e., increase value long-term)

EQUITY INCENTIVE PROGRAMS...COMMON THEMES

- Vesting
 - Time-based, performance thresholds, or a hybrid
- Termination of Employment
 - For cause or employee resigns without good reason
 - No cause termination by Company/good reason by certain executives
 - Death/disability
- Change of Control
 - Automatic acceleration (or Board discretion) – most common
 - Convert portion to options of acquirer or mandatory rollover percentage
 - Terminate Plan and settle for cash
- Require Execution of Stockholder/LLC Agreement
- 409A/Tax Treatment

PURCHASE AGREEMENT OVERVIEW

- **Sets forth the basic terms** and structure of the purchase of the Target's business
- **Confirms Buyer's due diligence review** through the Target's representations and disclosure schedules
- **Governs the conduct of the Parties** both pre- and post-Closing
- **Establishes the Parties' rights to terminate** the Agreement and the consequences of such termination
- **Allocates post-Closing risks** of the Target's business

THE BIG PICTURE

Sellers want:	Buyers want:
<ul style="list-style-type: none">Maximize priceQuick closingMinimal risk of not ClosingSail off into the sunset	<ul style="list-style-type: none">ExclusivityTime and process to obtain financingMinimal exposure if they fail to closeMinimal assumption of riskIndemnification (flip side of assuming risk)Restrictions on sellers' ability to compete post-closing

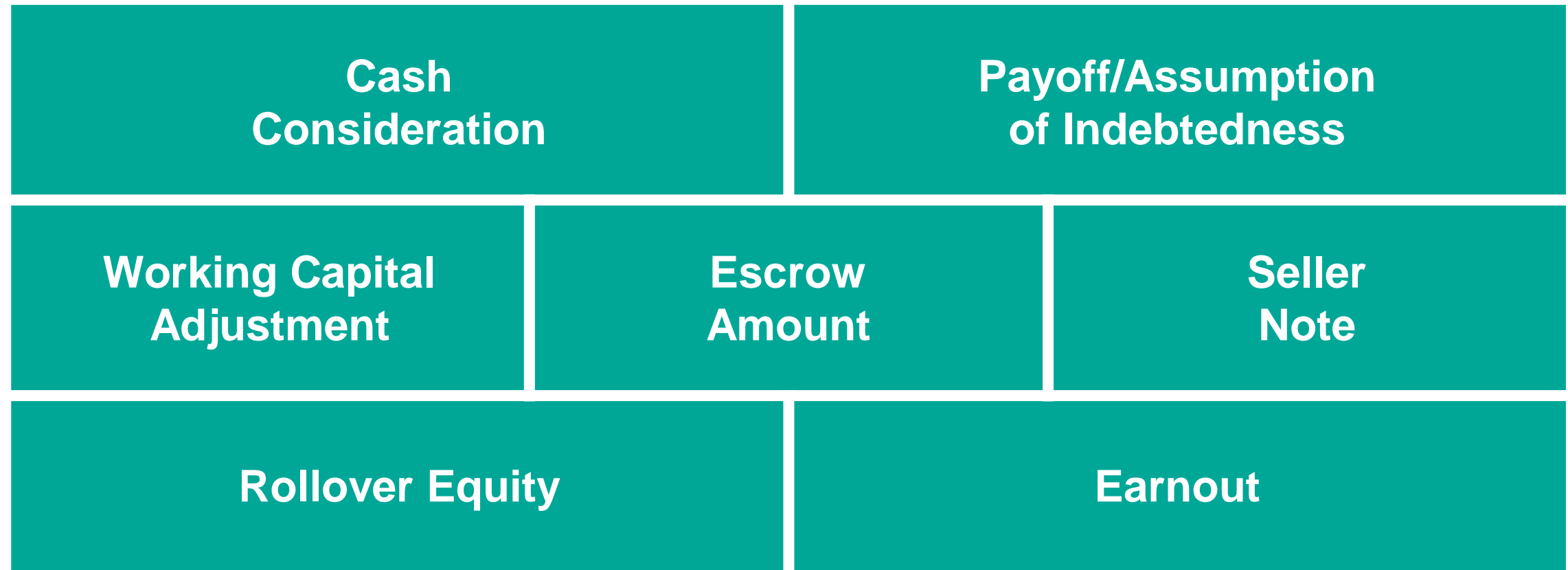
PURCHASE AGREEMENT STRUCTURE...

BIFURCATED VS. SIMULTANEOUS SIGN AND CLOSE

Simultaneous	Bifurcated
<ul style="list-style-type: none">• Simpler process but no one is bound to terms• Highly negotiated purchase agreement provisions can be ignored (e.g., pre-closing covenants, closing conditions, termination)	<ul style="list-style-type: none">• May be required for regulatory reasons (government approvals – e.g., antitrust, energy, healthcare, insurance, CFIUS, etc.)• Buyer may prefer to raise financing after signing the Agreement• Negotiations/documentation more complex & Target must comply with operational and other covenants during interim pre-closing period• Reps and warranties will be brought down at Closing.

PURCHASE PRICE

Comprised of a combination of these components...



PURCHASE PRICE ADJUSTMENTS

Private company deals are typically done on a cash free and debt free basis with normalized levels of working capital

- Accomplished by adjustments to “headline” purchase price (i.e., enterprise value) which may be done based on estimates pre-closing and **actuals** post-closing
- Purchase price is:
 - **Increased** by cash of the Company at closing
 - **Decreased** by debt of the Company at closing
 - **Increased** or **decreased** by working capital of the Company at closing in relation to agreed upon target

Example:

Headline Price:	\$100,000,000
Less Debt:	\$15,000,000
Working Capital Target:	\$4,000,000
Actual Working Capital:	<u>\$3,500,000</u>
Actual Cash to Seller:	\$84,500,000

PURCHASE PRICE ADJUSTMENTS

- **Working Capital**

- Current Assets of the Company **less** Current Liabilities of the Company (i.e., a balance sheet test)
- Method for calculating working capital is often a key area of negotiation (e.g., consistent with GAAP? Or with the company's prior practices?)
- Parties agree on target, and the purchase price is adjusted upwards or downwards based on the difference between the actual and the target

- **Cash**

- How to treat restricted cash (e.g., landlord deposits) or trapped cash (i.e., excess cash held offshore)

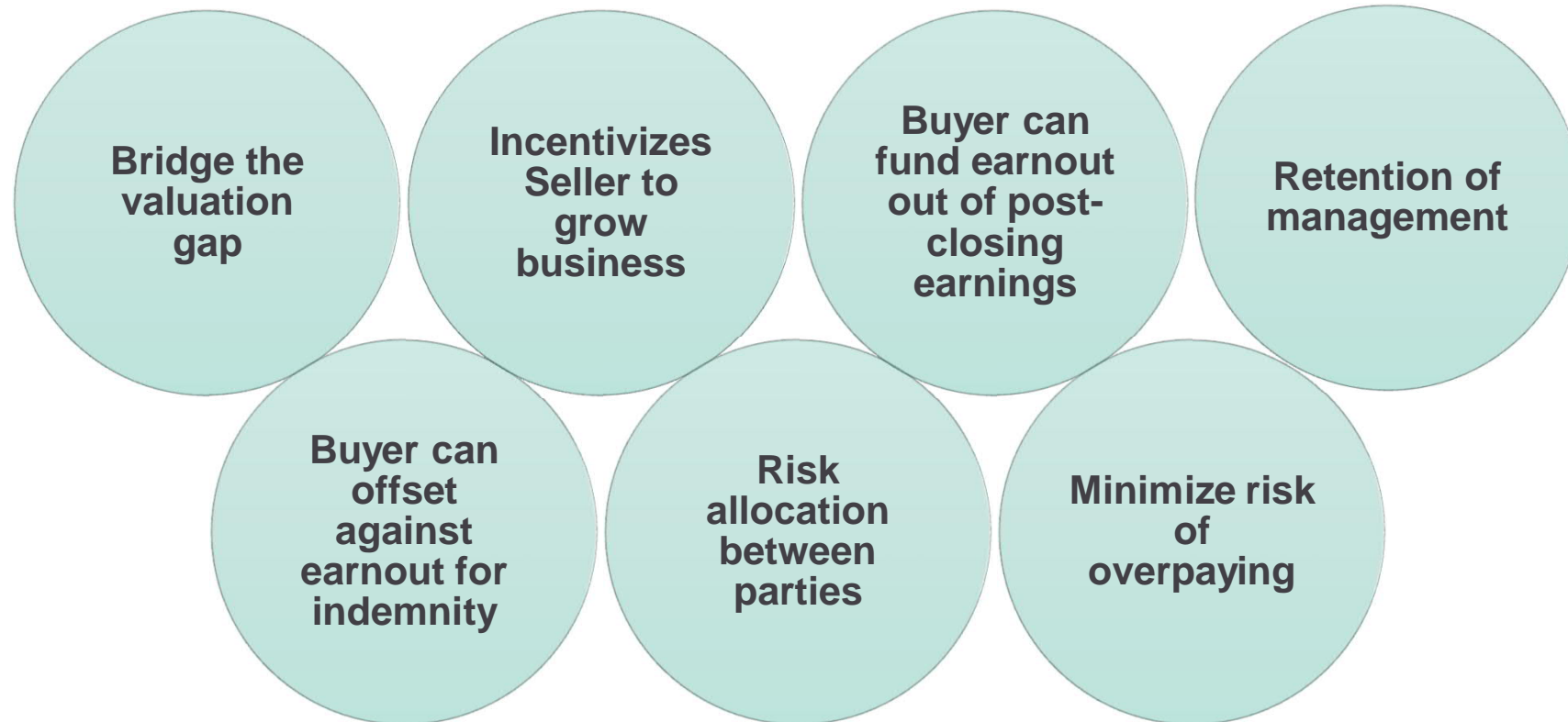
- **Debt**

- Not just borrowed money – often includes letters of credit, out-of-the-money derivative instruments, deferred revenue, prepayments by customers and other debt-like items

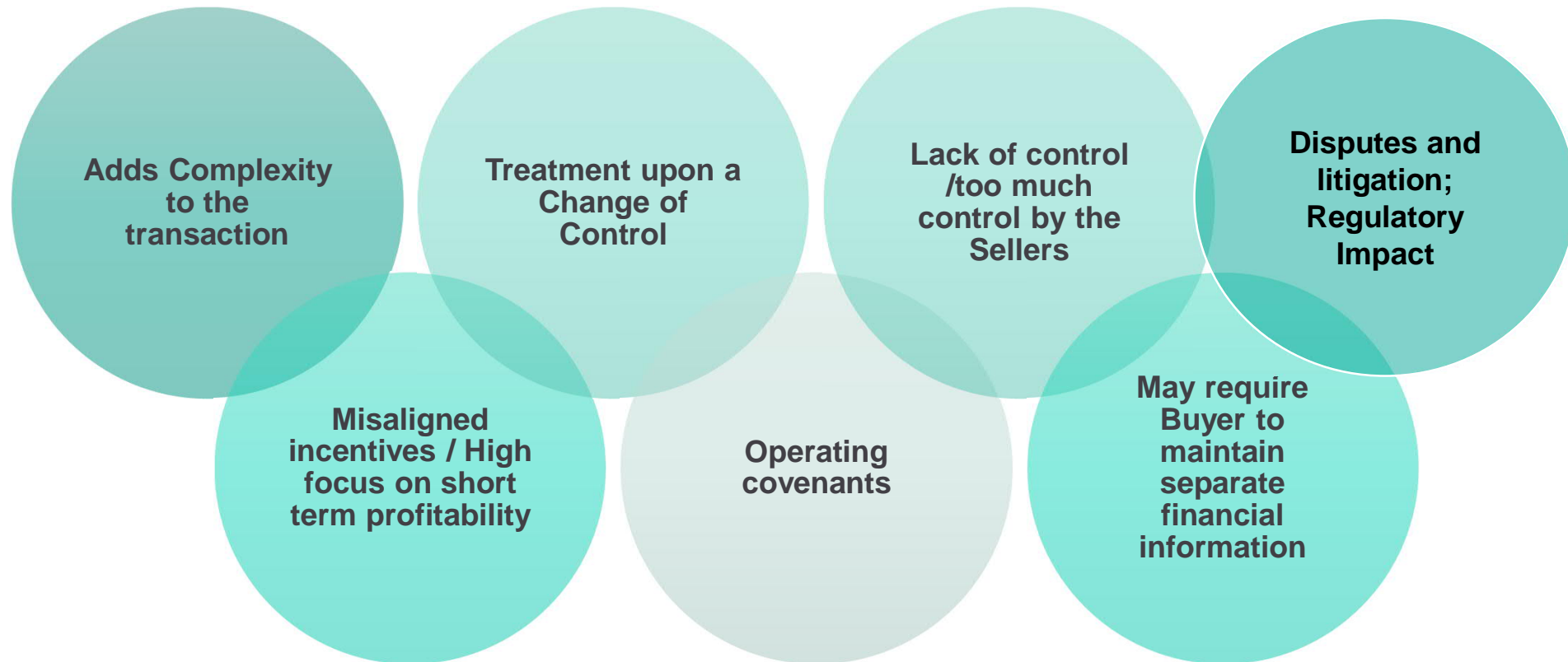
EARNOUTS...WHAT ARE THEY?

- **A tool to bridge the valuation gap...**
 - in the negotiation of the final Purchase Price for the sale of the Target's business
- **Earnouts provide additional consideration to the Sellers...**
 - by tying the payment of the “disputed” portion of the Purchase Price to the ***actual*** outcome of certain performance targets or certain events occurring or not occurring post-closing, including non-financial events
- **Very common in Life Sciences deals. Shorter earnouts more common in tech deals.**

EARNOUTS...THE POSITIVES



EARNOUTS...THE NEGATIVES



REPRESENTATIONS AND WARRANTIES

Reps & Warranties	Disclosure Schedules
<ul style="list-style-type: none">A series of factual statements and promises regarding the Parties, the transaction and the condition, nature and scope of the business being acquired	<ul style="list-style-type: none">A disclosure schedule is a list attached to an agreement setting forth exceptions to the factual statements and promises made by a party in the purchase agreement

Together...the Reps and Warranties and Disclosure Schedules provide the relevant statements made by Seller regarding the Target business

INCORPORATING DILIGENCE RESULTS INTO CERTAIN ASPECTS OF THE PURCHASE AGREEMENT

Reps & Warranties	Disclosure Schedules
<ul style="list-style-type: none">• Adjust scope of reps and warranties based on nature of business and diligence findings. For example:<ul style="list-style-type: none">– More expansive health care representations (payors, HIPAA, Stark, data privacy) in a business where health care is a major portion of the business– Inversely, other representations may be shortened due to less importance to the business (i.e. environmental, intellectual property, real estate)	<ul style="list-style-type: none">• Can reveal additional information that potentially impacts negotiation of reps, warranties and covenants• Schedules may disclose findings that are inconsistent with diligence findings• Disclosure may impact indemnification rights

CLOSING CONDITIONS

Closing conditions are commonly negotiated and can include...

Buyer obtaining financing

Employment agreements/incentive equity plan

Consent under certain contracts or permits

Regulatory approvals (e.g., HSR)

Customer calls

No “Material Adverse Effect” has occurred and the reps and warranties made at signing remain accurate (to some standard)

TERMINATION

- **In a bifurcated sign and close**, sets forth when the agreement can be terminated (e.g., drop dead dates, breaches of closing conditions, absence of financing following a marketing period)
- **Implications of Termination**
 - What provisions survive (including indemnification obligations)
 - Reverse termination fees

COVENANTS...BY THE SELLER

Pre-closing operation of the business	Non-competition
General release	Financing covenants
Non-solicitation (employee and customer) and no-hire	Confidentiality (non-disclosure and non-use)

INDEMNIFICATION...WHAT IS IT?

Indemnification is the obligation of a party (e.g., Seller) to bear the costs and expenses of specified losses incurred by another party (e.g., Buyer)

WHO INDEMNIFIES?

Buyers. Sellers. And sometimes parent entities...

Typically each indemnify each other for damages caused by such party's breach of its representations, warranties or covenants

Who is really at risk? The Seller.

It is much more likely that a Buyer will have an indemnification claim against a Seller than vice versa

- Also...Joint & Several Liability vs. Several (and not joint) Liability
- Buyer prefers for Seller's stockholders to be jointly and severally liable
 - Seller's stockholders prefer for their liability to be several and not joint

WHAT IS COVERED?

Breaches of rep & warranties

Breaches of covenants

Pre-closing taxes

Specific indemnities

INDEMNIFICATION FOR... REPRESENTATIONS AND WARRANTIES BREACH

- **Representation and Warranty**

- Example: “Except as set forth on Section 3.12 of the Disclosure Schedule, the Company and its Subsidiaries are, and during the last 3 years have been, in compliance in all material respects with all Laws.”

- **Disclosure Schedule**

- Example: “On April 11, 2015, the Company received notice that certain of its employees made illegal payments to zoning officials in connection with 6 distribution centers located in Mexico.”

Impact of Disclosure on Indemnification Rights

Since disclosure modifies the representations and warranties, if a liability is disclosed then there is no breach and thus no indemnification.

To be indemnified, Seller would need to seek a specific indemnity with respect to the disclosed item.

LIMITATION ON INDEMNIFICATION

Parties will negotiate over various terms to limit or expand indemnification obligations

Definition of “Damages”	Dollar Limitation (deductibles, baskets and caps)	Time Limitations
Substantive Limitations (tax benefits, insurance proceeds)	Line-Item Indemnities	Sand Bagging

DOLLAR LIMITATIONS

Deductible	Threshold or “tipping basket”	“Mini Basket”
<ul style="list-style-type: none">A party need not indemnify the other for certain liabilities unless the damages exceed a minimum amount	<ul style="list-style-type: none">A party need not indemnify the other unless damages exceed a minimum amount, however...Once this minimum amount has been reached, the damaged party may seek indemnity for all of its damages (i.e., from the first dollar)	<ul style="list-style-type: none">Individual losses must exceed a de minimis threshold to be subject to indemnificationWorks with Cap and Threshold to provide greater limitations on indemnification obligations

TIME LIMITATIONS

- **Representations made by a private company Seller typically survive for 12-24 months after Closing, with certain exceptions:**
 - Representations relating to employee benefit matters, tax matters and environmental matters may survive for a longer period of time (or even the applicable statute of limitations)
 - Representations relating to organization, authority, capitalization and stock ownership (or title to assets in an asset deal) may survive indefinitely (these are what are typically considered to be the “Fundamental” reps and warranties)
 - Fraud

SATISFYING OBLIGATIONS...

SOURCES OF RECOVERY

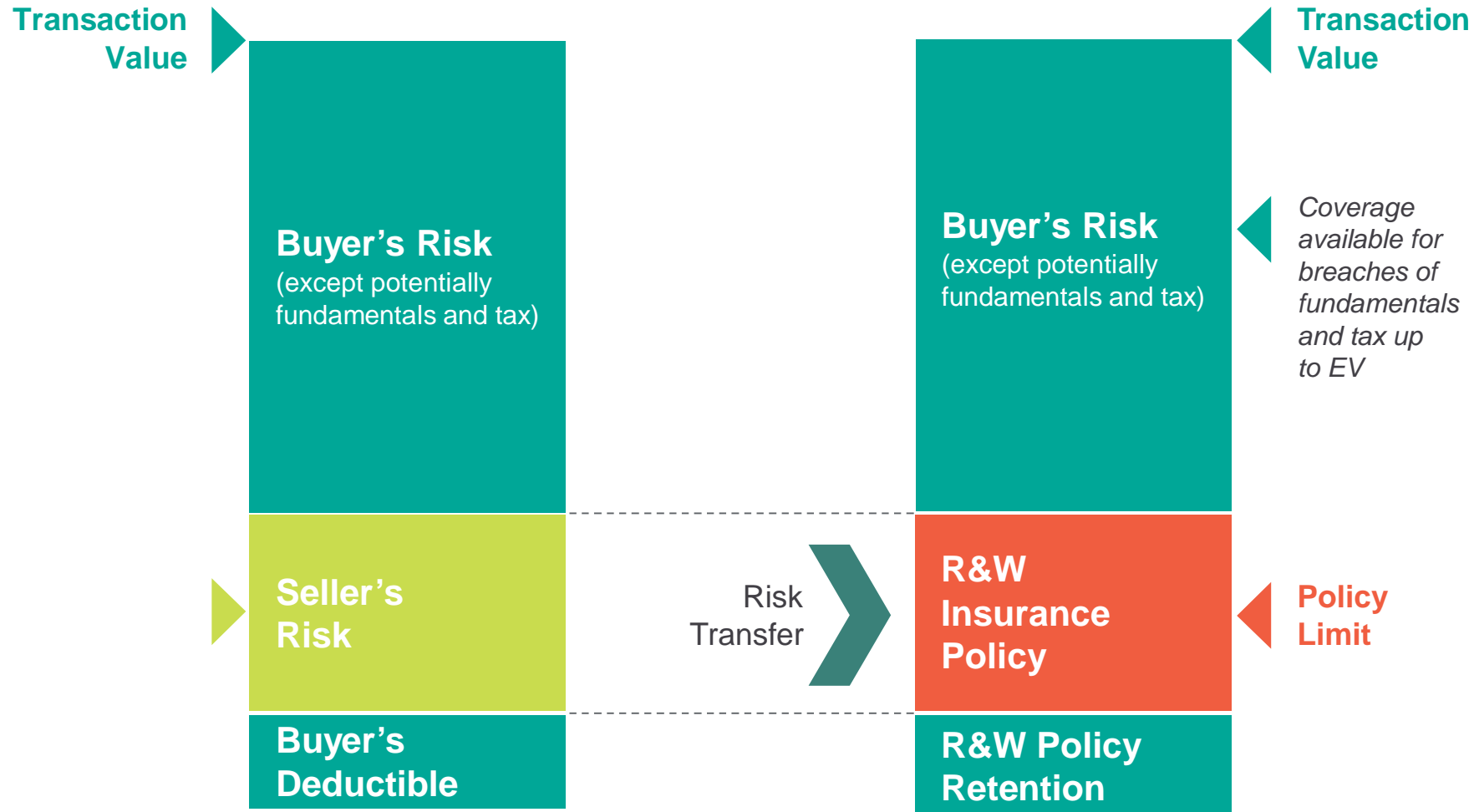
- **Direct recovery from Seller**
- **Holdback from the Purchase Price**
- **Escrow**
 - Deposit cash with a third party (usually a bank) for a specified time period, which is later disbursed to the parties upon the occurrence of certain negotiated events
 - Escrow particularly important if Buyer has concerns with the credit-worthiness of the Seller post-closing
- **Rights of Setoff**
 - Setoff rights against Seller Note, Earnout or other post-closing payments to the Seller
- **Representation and Warranty Insurance**

REPRESENTATION AND WARRANTY INSURANCE

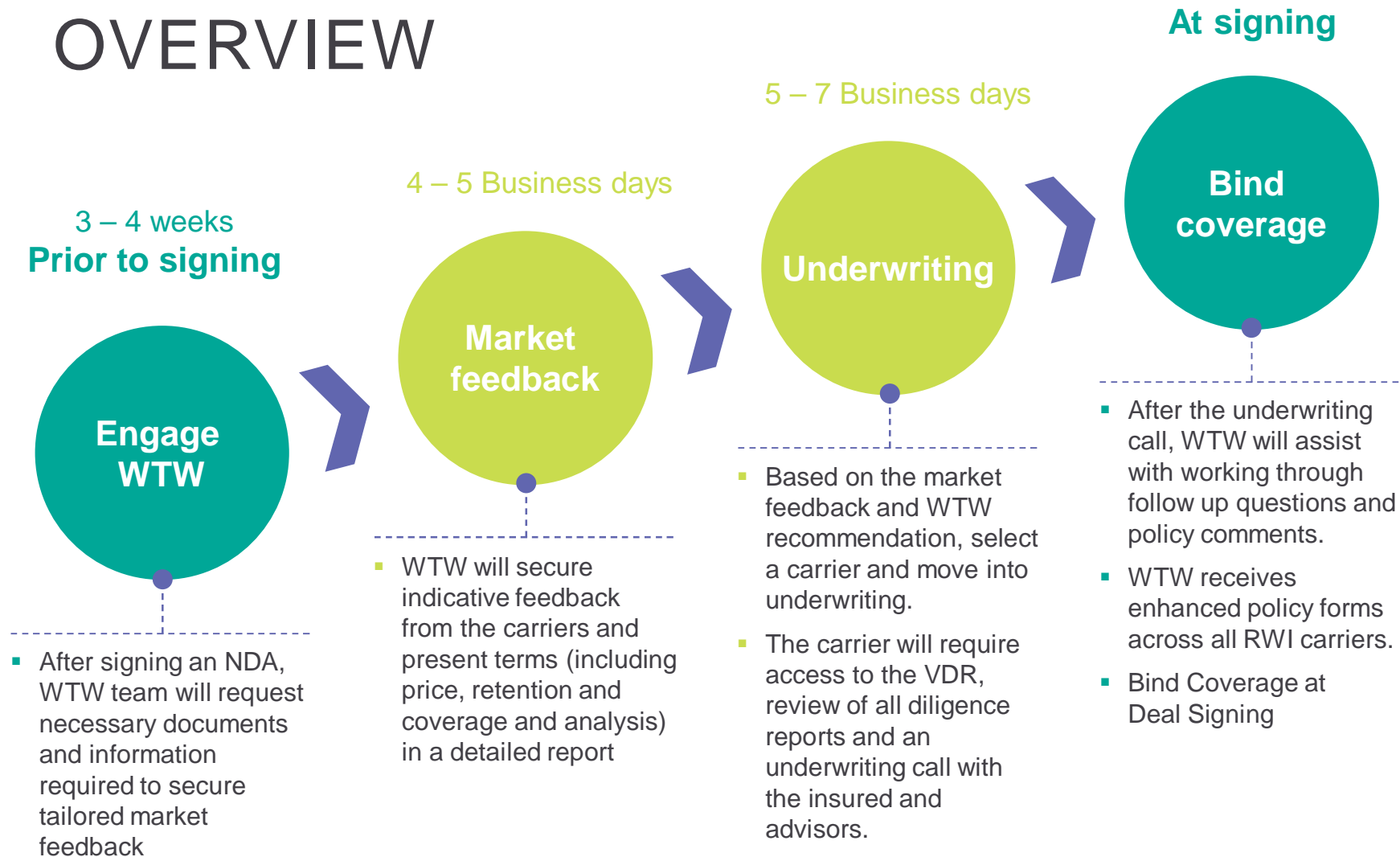
Benefits and Uses

Buyers	Sellers
<ul style="list-style-type: none">• Receive broader representations under a policy than sellers may otherwise offer	<ul style="list-style-type: none">• Collect proceeds up front without funds tied up in escrow
<ul style="list-style-type: none">• Benefit from extended survival periods (customarily 3 years for general representations & 6 years for fundamental representations)	<ul style="list-style-type: none">• Avoid post-closing contingent liabilities and proceedings
<ul style="list-style-type: none">• Avoid post-closing proceedings with sellers who may remain active at the company	<ul style="list-style-type: none">• Reduce the risk of prolonged or contentious negotiation over representations and indemnification provisions in a transaction agreement
<ul style="list-style-type: none">• Benefit from security where there is a concern over the ability to collect indemnification	<ul style="list-style-type: none">• For minority and passive investors, receive protection from any indemnity obligations arising out of joint and several liability obligations

RISK TRANSFER MIRRORS BACK-TO-BACK WITH SPA



RWI HIGH LEVEL PROCESS OVERVIEW



OVERVIEW: BUYER-SIDE COVERAGE

- Over 99% of RWI policies are buyer-side policies

RWI insurance

Term

- 3 years for General Reps
- 6 years for Fundamental reps
- Coverage for 6 years for all reps may be available depending on the deal characteristics

Limit

- Insureds select the coverage limit amount according to preference and risk appetite
- Coverage available for excess fundamentals and tax risk

Retention

- Typically, 1.0% of deal value
- Most commonly either split 50/50 or follow a “no seller indemnity” structure
- Over 65% of our placed policies YTD took the form of “no seller indemnity:”

Fraud

- Buyer-side policies cover seller fraud (the definition of fraud is reviewed by underwriters), so long as the insurer maintains subrogation's rights

QUESTIONS?



THANK YOU.

