HEALTHCARE PRIVATE EQUITY ASSOCIATION

HCPEA New Associate Training – Welcome to the 101!

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PRINCIPAL TRANSACTION AGREEMENTS: *AGENDA AND TRAINING GOALS*

1. **Understanding Principal Transaction Agreements**
   - Parts of an Agreement
   - Basic Function
2. **Working Capital Adjustments**
   - Common Tensions between Buyers and Sellers
3. **Indemnification Matters**
   - Typical Formulations
   - Specific Objectives
   - Common Pitfalls to Avoid
   - Role of Rep & Warranty Insurance
4. **What about Fraud?**
5. **Closing Conditions, Termination Provisions and Remedies for Failure to Close**
   - When must the deal close, when may a party walk away and what happens if they do

PART I: UNDERSTANDING PRINCIPAL TRANSACTION AGREEMENTS

PRINCIPAL TRANSACTION AGREEMENTS:
BASIC OBJECTIVES

- Reflect the **business deal and commercial terms** to which the parties have agreed
- Create a **road map** to govern the parties' conduct pre- and post-closing
- Establish the conditions governing when the transaction **must close**, the situations in which the parties may **walk away** from a deal and the **consequences**, if any, for walking away
- Protect the **"benefit of the bargain"** the parties have negotiated for
- **Allocate risk** among the parties

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 or stock of Buyer)

CATEGORIES OF NEGOTIATED ACQUISITION TRANSACTIONS:
KEY STRUCTURING CONSIDERATIONS

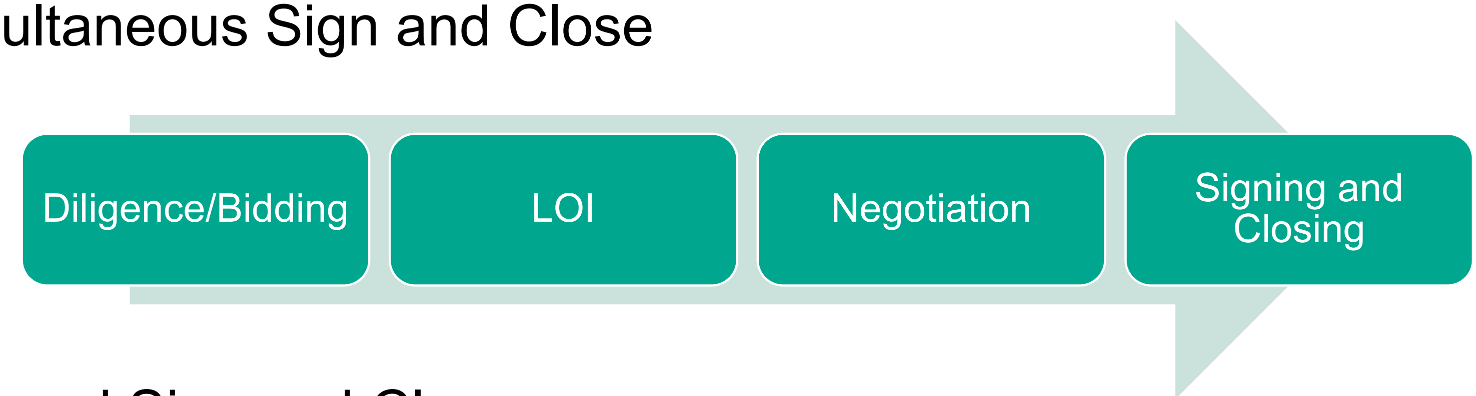
Consideration	Asset	Stock	Merger
Cherry Pick Assets and Liabilities?	• Yes • Buyer – good o Successor liability/de facto merger • Seller – not good	• No • SPV • Indemnification	• No • SPV • Indemnification
Tax **(C-corp)**	• Double • Buyer gets step up	• Single • 338(h)(10)	• Forward – asset • Reverse - stock
Complexity increases as SH base increases ("not small")	• No	• Yes	• No
Process	• More complicated: ID and transfer each asset/liability (e.g. real estate, contracts, etc.) • Bulk sales • Bill of sale	• Everything Goes • Stock power	• Everything Goes • Appraisal Rights
Consents (assignments) – Third Party	• Likely	• Only if COC	• Forward – yes • Reverse - No
Consents- Corporate (Board and SH)	• Yes	• Yes	• Yes

SUMMARY OF BASIC STRUCTURES FOR CORPORATE ACQUISITIONS TAX CONSEQUENCES

Stock Purchase/Merger		Asset Purchase	
Seller	Buyer	Seller	Buyer
• One level of tax • Capital gain (higher or lower rate depending on holding period)	• No step-up in asset basis unless LLC/Partnership target or S corp. target with 338(h)(10) election • Inherit target tax attributes and audit risk • Subject to certain limitations, Buyer acquires benefit of the Target's net operating losses	• Potentially two levels of tax for Seller (for C corp targets) • Potential ordinary income tax rates applied to a portion of the gain (for pass-through targets)	• Asset basis step-up • Amortization deductions (intangibles amortized over 15 years) • Anti-churning rules where Target is a pre-1993 business and rollover equity is involved

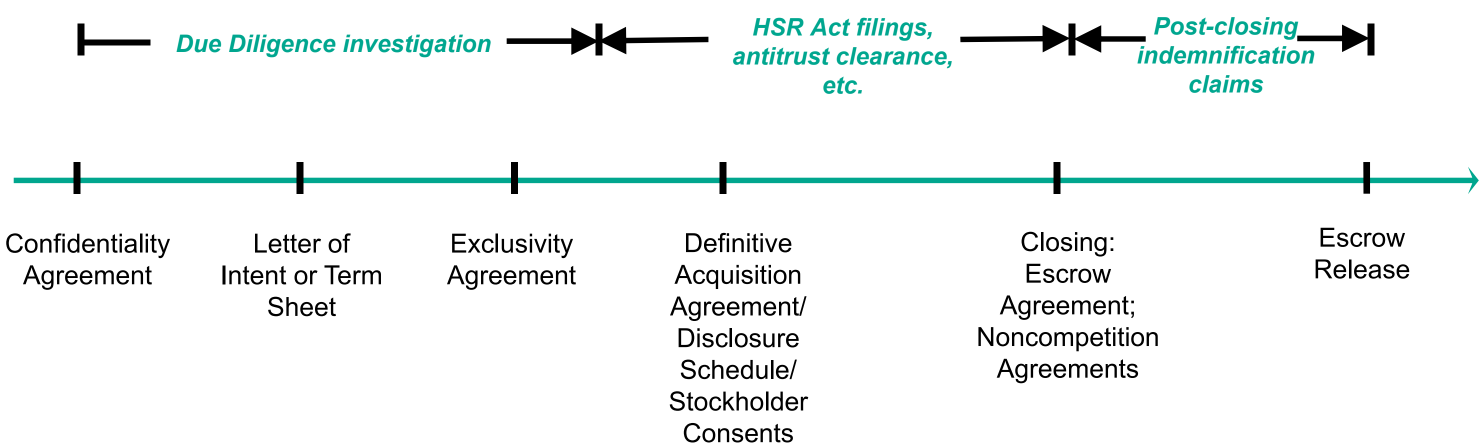
THE TRANSACTION:
TYPE

Simultaneous Sign and Close



Delayed Sign and Close

SAMPLE ACQUISITION CHRONOLOGY (PRIVATE TARGET)



PURCHASE AGREEMENT STRUCTURE:
BIFURCATED VS. SIMULTANEOUS SIGN AND CLOSE

Simultaneous	Bifurcated
• 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)	• 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.

REPRESENTATIONS AND WARRANTIES

Reps & Warranties	Disclosure Schedules
• A series of factual statements and promises regarding the Parties, the transaction and the condition, nature and scope of the business being acquired	• A disclosure schedule is a list attached to the purchase/merger agreement setting forth exceptions to the factual statements and promises made by a party in such agreement

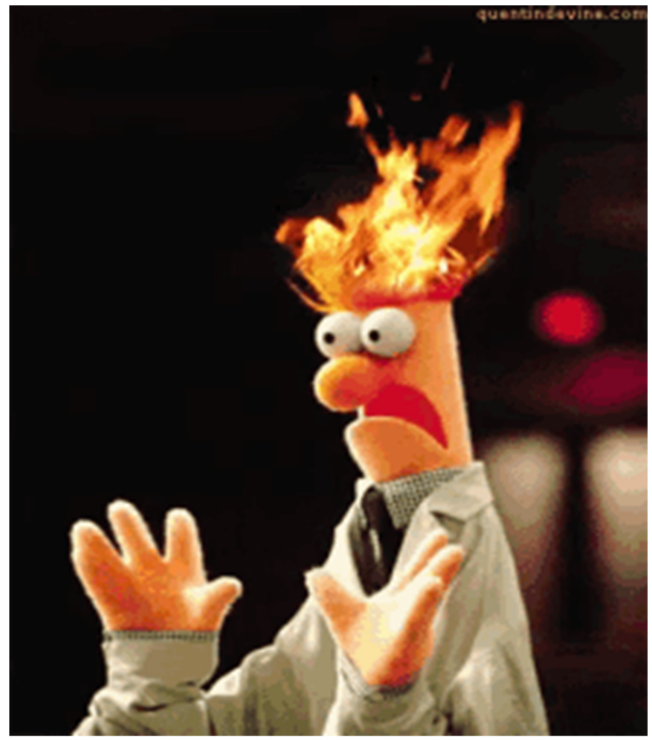
Together…the Reps and Warranties and Disclosure Schedules provide the relevant statements made by Seller regarding the Target business

INCORPORATING DILIGENCE RESULTS INTO CERTAIN ASPECTS OF THE PURCHASE AGREEMENT

Reps & Warranties	Disclosure Schedules
• Adjust scope of reps and warranties based on nature of business and diligence findings. ***For example:*** – 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)	• 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

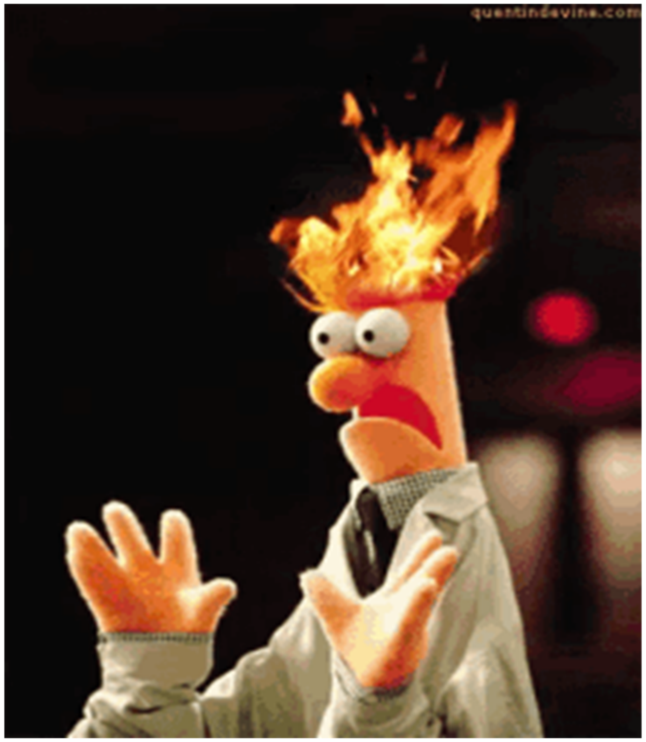
PRELIMINARY STAGES OF AN ACQUISITION: *BUYER'S "DUE DILIGENCE" INVESTIGATION*

- 3-Steps
  - Identify the risk
  - Assess the risk
  - Remedy the risk
- Known Risks
  - Assessing
    - How much?
    - How likely?
    - How long?



PRELIMINARY STAGES OF AN ACQUISITION (CONT'D): *BUYER'S "DUE DILIGENCE" INVESTIGATION*

- Known Risks (cont'd)
  - Remedying
    - Accept
    - Walk
    - Purchase price adjustment
    - Contingent payments/Earnouts
    - Walk right (closing condition)
    - Indemnification
- Allocating Unknown Risk



SELLER COVENANTS

Pre-closing operation of the business	Non-competition
General release	Non-disparagement; Confidentiality
Non-solicitation (employee and customer) and no-hire	Exclusivity/No-Shop

BUYER COVENANTS

Regulatory Consent (HSR)	**Employee Benefits**
Confidentiality	**Publicity**
Tax Matters	**D&O Indemnity**

PART II: WORKING CAPITAL ADJUSTMENTS

PURCHASE PRICE

Comprised of a combination of these components…

Cash Consideration

Payoff/Assumption of Indebtedness

Working Capital Adjustment

Escrow Amount

Seller Note

Rollover Equity

Earnout

PURCHASE PRICE ADJUSTMENTS:
TYPICAL FORMULATION

The "Closing Purchase Price" shall be equal to:

1. the Base Purchase Price;
   a) *plus*, the Closing Cash;
   b) *plus*, if the Net Working Capital Estimate exceeds the Target Net Working Capital, the amount of such excess;
   c) *minus*, if the Target Net Working Capital exceeds the Net Working Capital Estimate, the amount of such excess;
   d) *minus*, the Escrow Amount;
   e) *minus*, the Closing Debt; and
   f) *minus*, the Company Expenses.

NET WORKING CAPITAL:
KEY DEFINITIONS

- "Current Assets" means, as of the ***Effective Time***, the consolidated current assets of the Company and its Subsidiaries, ***which current assets shall include only the line items set forth in Annex A under the heading "Current Assets" and no other assets.***

- "Current Liabilities" means, as of the ***Effective Time***, the consolidated current liabilities of the Company and its Subsidiaries, ***which current liabilities shall include only the line items set forth in Annex A under the heading "Current Liabilities" and no other liabilities***.

NET WORKING CAPITAL:
KEY DEFINITIONS

- GAAP is a set of accounting principles, standards and procedures *not* hard and fast rules
  - GAAP recognizes multiple acceptable methods for accounting for items:
    - *Ex*. AR – flexibility in how to reserve for doubtful accounts
    - *Ex*. Inventory – flexibility in the manner in which obsolete/non-saleable inventory is addressed
  - Under GAAP an event that occurs during a subsequent-events-period that provides additional evidence about conditions existing at the balance sheet date may result in an adjustment to the financial statements

RELYING ON A GAAP STANDARD ALONE MAY OPEN THE DOOR TO POST-CLOSING DISPUTES

NET WORKING CAPITAL:
KEY DEFINITIONS

- "*Net Working Capital*" means, the Current Assets minus the Current Liabilities, as of the Effective Time, calculated ***in accordance with the Accounting Principles.***

- "*Accounting Principles*" means, collectively, the accounting principles, methods and practices used in preparing the Financial Statements for the year ended December 31, 2020 to the extent in accordance with GAAP, applied on a consistent basis, and the rules set forth in Exhibit A.

NET WORKING CAPITAL: *KEY DEFINITIONS*

- ***Specific Accounting Rules:***
  - *Ex. Accounts Receivable*: The reserve for doubtful accounts for accounts receivable over ninety days old as of the Effective Date will be 20%.
  - *Ex. Inventory*: Buyer may require, upon at least twenty (20) Business Days advanced written notice to the Seller, that the Seller cause the Company to perform a physical count of all inventory prior to Closing. The results of any physical inventory counts will be incorporated into the calculation of Net Working Capital. Representatives of the Buyer, including but not limited to its auditors, shall have the right to be present at and observe the physical inventory count as well as review the results of the physical inventory count and all subsequent adjustments due to the physical inventory count.
- ***General Rules***:
  - *Ex*. For the avoidance of doubt, Net Working Capital shall be calculated without giving effect to the closing of the transactions contemplated by [this Agreement] and shall be based exclusively on the facts and circumstances as they are known to exist by the Company as of the Closing and shall exclude the effect of any event, act, change in circumstance or similar development arising or occurring thereafter (including the Company acquiring knowledge after the Closing (for the first time) of any fact or circumstance existing as of the Closing).

PART III: INDEMNIFICATION MATTERS

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

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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

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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**

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**	**Sandbagging**

IMPACT OF REP & WARRANTY INSURANCE

- Reduced Liability Exposure to Seller
  - Shorter Survival of Claims
  - Smaller Financial Exposure

Recourse	General Cap on Exposure
Standard (Seller Only)	Cap on Most Claims* generally = 5% - 10% EV **Fundamental Reps, taxes and specified other reps often have a higher cap (purchase price or in some instances no cap at all)*
R&W Policy	Loss Retention Under Policy (e.g., 2% EV) less Deductible (e.g., 0.5% EV) = 1.5% EV* * *Policy Exclusions may be handled separately*

- Less Contentious Negotiation of Reps
- Buyer Generally Receives Enhanced Rep Coverage
  - Broader Scope of Rep Coverage
  - Longer Survival Under Rep & Warranty Policy
- Addressing Exclusions (through direct indemnity, separate escrow or specific insurance products)

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, Holdback, Earnout or other post-closing payments to the Seller
- **Representation and Warranty Insurance**

PART IV:
WHAT ABOUT FRAUD?

FRAUD:
SELLER V. BUYER

- *Delaware law permits sophisticated parties to contractually limit the universe of information that the buyer has relied upon as the “factual predicate” for the buyer’s decision to enter into an acquisition agreement.*

- Seller Concerns:
  - Prefer limited liability; only express reps and warranties made in the “four corners”
  - Concern whether contract expands undefined fraud to include “innocent” Sellers
  - PE funds would like limited recourse against non-parties when selling portfolio companies
  - Limited personal liability
- Buyer Concerns:
  - Preserving remedy by negotiating broader contractual fraud carveout
  - Ideally would like to include reps and warranties made outside the “four corners”
  - Fraud claim would carve out a path to recovery even beyond the contractual limitations
  - Avoid giving Seller a “license to lie”

FRAUD:
EXTRA-CONTRACTUAL V. CONTRACTUAL

Extra-contractual	Contractual
• Discussions over dinner • Oral communications • Email correspondence • Data room documents **** Can be limited by non-reliance clause**	• Representations and warranties made in a SPA • Representations and warranties made in a certificate **** Cannot be waived by contract**

WHAT ABOUT FRAUD

What impacts fraud?

Non-reliance provision	**Definition of Fraud**	**Definition of Knowledge**
Exclusive Remedies Provision	**Whose fraud counts**	**Buyer/Seller's conduct**

WHAT ABOUT FRAUD

- Most extra-contractual M&A fraud claims are made by buyers against sellers.
- Not all fraud claims require knowing communication of a lie (i.e., reckless and not intentional, equitable fraud)
- Well crafted exclusive remedies provision → severely limits the type/nature of fraud claims
- Is this a license to lie? Yes except for: knowingly conveying a falsehood in the written reps and warranties.

TAKEAWAYS

- Seller v. Buyer will push for limited/expanded fraud remedies in contract.
- Seller can be liable for permitting a fraud, even if not knowingly committing the fraud.
- Your actions still matter even in the context of the negotiated contract.
  - Being forthcoming and establishing a record helps
- Is there too much dynamite?
- No survival claim does not defeat contractual fraud claims when the contract itself is an instrument of fraud.

PART V: CLOSING CONDITIONS, TERMINATION PROVISIONS AND REMEDIES FOR FAILURE TO CLOSE

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)

Physician Credentialing

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

NEGOTIATING BUYER’S “WALK RIGHTS”

- Parties’ mindsets in negotiating buyer’s “walk rights”
  - **Buyer**: “we should have the right to walk away if target’s business deviates from our expectations in any material respect”
  - **Target**: “once the acquisition agreement is signed and publicly announced, our position vis-à-vis our employees, customers and others changes dramatically; if buyer walks away, we will be seen as ‘damaged goods’; accordingly, buyer should be permitted to walk only in the event of something truly catastrophic”

NEGOTIATING BUYER'S "WALK RIGHTS" (CONT'D):
"BRING-DOWN" CONDITION

Sample closing condition – "**bring down**" condition:

"The obligation of Buyer to effect the Merger is subject to the satisfaction of each of the following conditions:

*(a) Each of the representations and warranties of Target, other than the Fundamental Representations, shall be accurate in all respects as of the Closing Date as if made on and as of the Closing Date, except that any inaccuracies in such representations and warranties will be disregarded if the circumstances giving rise to all such inaccuracies (considered collectively) would not reasonably be expected to have or result in a **Material Adverse Effect**.*

*(b) Each of the Fundamental Representations shall be accurate **in all material respects** as of the Closing Date as if made on and as of the Closing Date."*

QUESTIONS?

THANK YOU.