



HEALTHCARE PRIVATE EQUITY ASSOCIATION 201: 99 PROBLEMS MORE THAN 101

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Joanna Lin, Partner, Dallas

Joanna focuses her practice on corporate, securities and transactional matters. Along with many types of transactions, she handles domestic and cross-border venture financing, mergers and acquisitions for public and private companies, and complex transition services agreements. She also has experience with capital markets transactions, having represented US and international issuers, investment banks and investors in a wide range of securities offerings, including initial public offerings (IPOs), follow-on offerings and private placements of equity securities. Joanna also regularly counsels clients on matters ranging from corporate governance to US Securities and Exchange Commission periodic reporting requirements and other general corporate matters.

Thaddeus Chase Jr., Partner, Dallas

Thaddeus represents clients in a wide range of corporate matters, mainly regarding buy-side and sell-side mergers and acquisitions for public and private companies. His experience includes advising clients in a variety of industries, including healthcare, technology and consumer products, with respect to mergers and acquisitions, internal restructurings, divestitures, corporate carve-outs, debt and equity investments, securities offerings and other general corporate governance matters. Thaddeus also provides pro bono services for various nonprofit organizations, including formation of new 501(c)(3) entities.

Alex Farr, Partner, Dallas

Alex focuses his practice on federal income and international tax planning for partnerships, corporations, and individuals related to complex domestic and international business transactions across a variety of industries, including the technology, healthcare, real estate and energy sectors.

Alex advises private equity funds, portfolio companies and public companies with respect to strategic mergers, acquisitions and reorganizations. He also has significant experience with investment fund formation and structuring matters, advising both fund sponsors and limited partner investors.

Jay Heidbrink, Director, Willis Towers Watson

Jay has over 12 years of experience in the legal industry both as in-house commercial counsel and private practitioner. In his role at Willis, Jay is responsible for the development and implementation of risk solutions for M&A transactions, including the deployment of insurance lines such as representations and warranties, litigation, tax and other contingent risk insurance. Based in Dallas, Jay is supported by a global team of more than 40 senior brokers.

Prior to joining Willis Towers Watson, Jay served as Assistant General Counsel at Hunt Oil Company in Dallas, Texas from 2014 to 2019.

AGENDA

201 Agenda

- | | |
|---|--------------------|
| • Introductions & Kickoff | 9:00 – 9:05 a.m. |
| • Tax Structuring Considerations | 9:05 – 9:35 a.m. |
| • Principal Transaction Agreements | 9:35 – 10:00 a.m. |
| • What you need to know about Reps and Warranties Insurance | 10:00 – 10:30 a.m. |
| • Other Key Legal Documents | 10:30 – 10:45 a.m. |
| • Recent Market Trends | 10:45 – 11:00 a.m. |

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?**

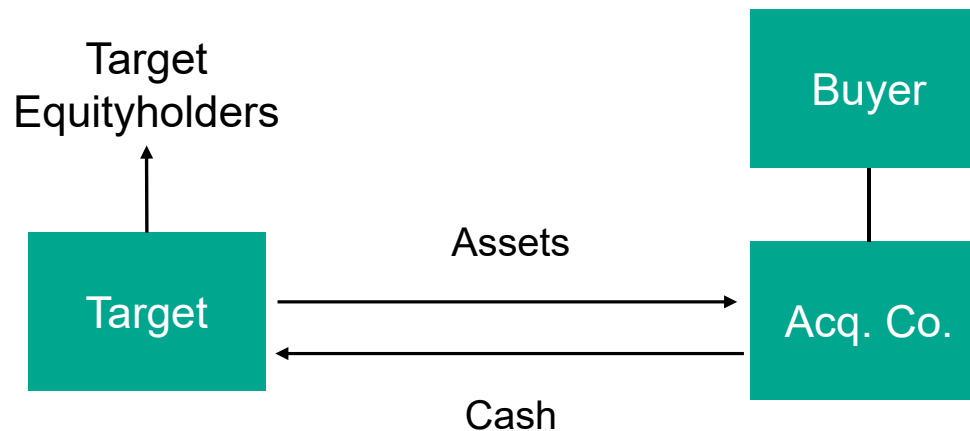
- Allows Buyer to pick and choose assets and liabilities
 - Often used in a transaction in which you are splitting up a business
 - Also used by Buyer to avoid certain historic entity-level liabilities (e.g., environmental, regulatory, taxes)
 - Can help address Buyer's concern with Seller's ability 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?**

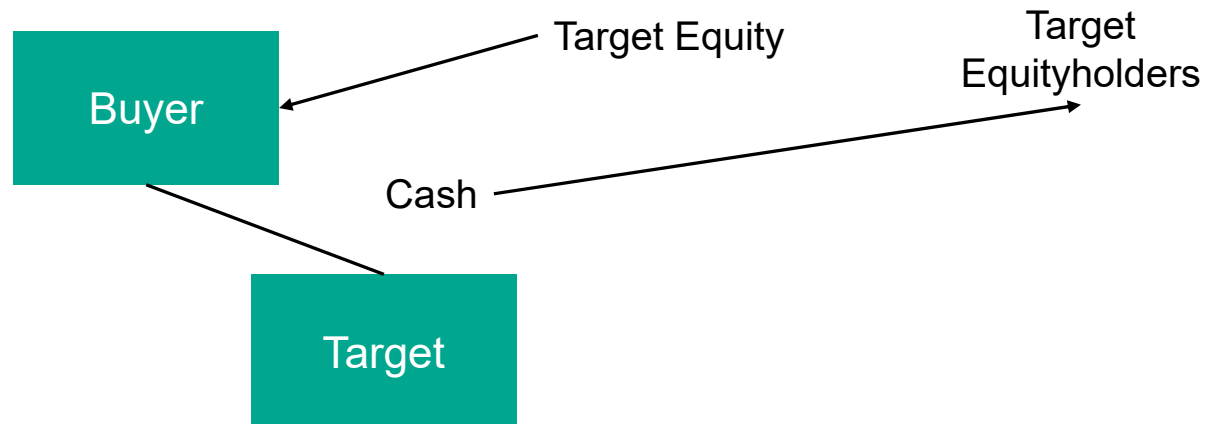
- Cleanest break for Seller
- Simpler to transfer the business in many cases
- Usually only results in one level of tax to Seller and generally at capital gains tax rates
- May facilitate favorable tax attributes of Target transferring to Buyer (subject to certain limitations)

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?**

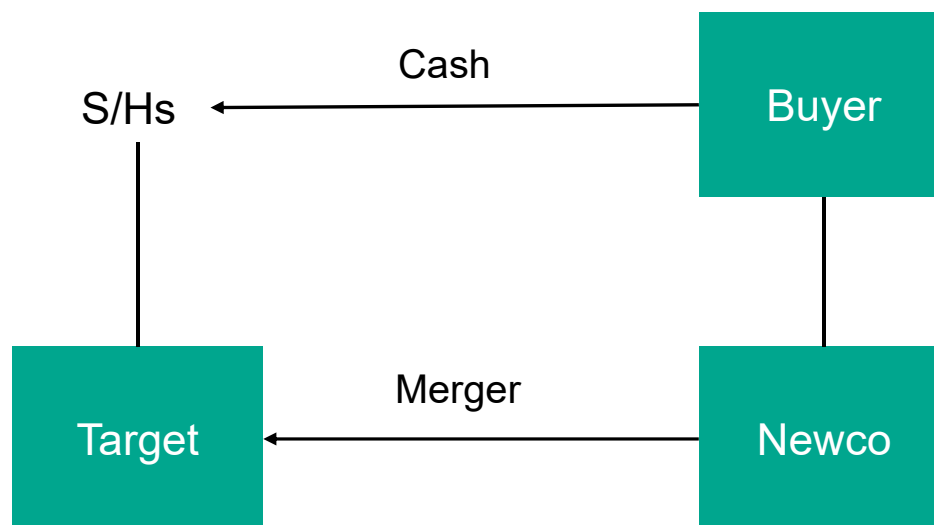
- Common transaction structure for acquiring a public company or a private company with many equityholders
- Allows buyer to acquire equity without having to orchestrate the tendering of equity by many equityholders, subject to appraisal (dissenters) rights
- Good structure for a Private Equity Seller 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:

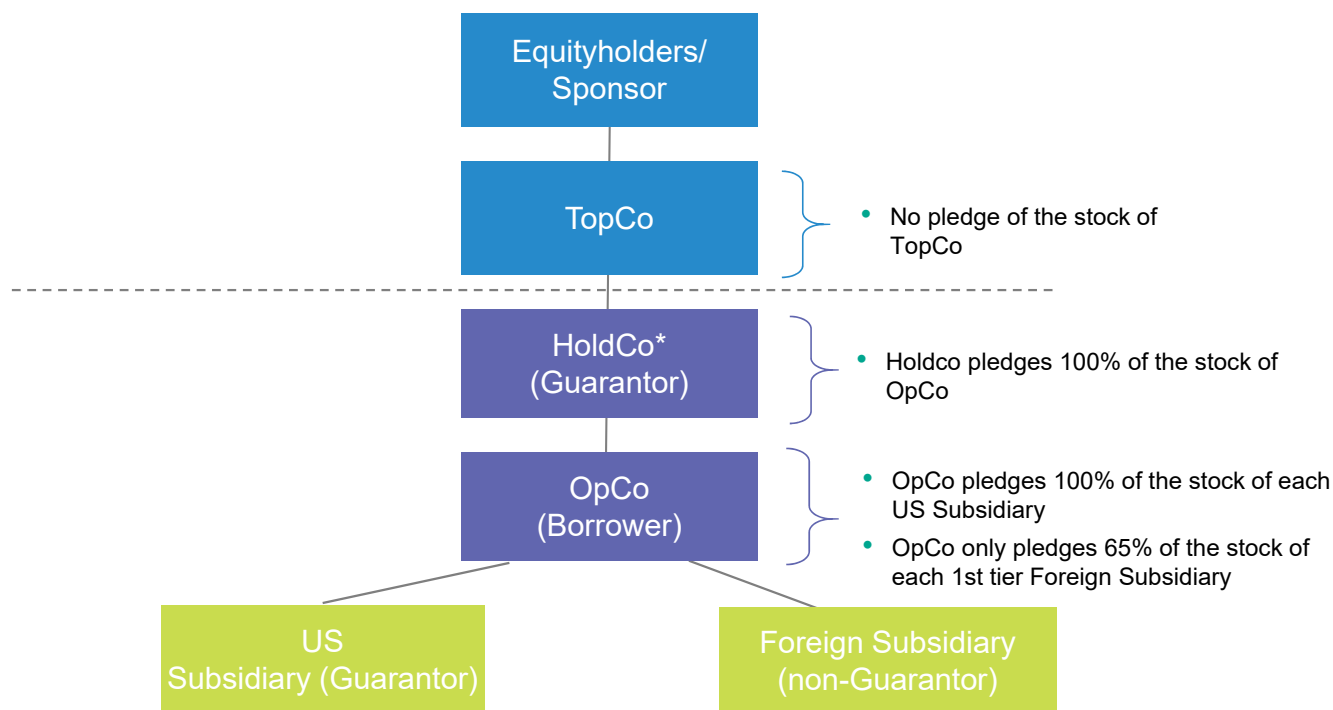
- Transitory Newco merges into Target under state law
- Buyer's stock in Newco converted into Target stock
- No asset transfer

SUMMARY OF TAX CONSIDERATIONS FOR BASIC ACQUISITION STRUCTURES

Stock Purchase/Merger		Asset Purchase	
Seller	Buyer	Seller	Buyer
<ul style="list-style-type: none"> • One level of tax • Generally recognizes capital gain on sale (applicable rate depends on holding period) • Potential ordinary income tax rates applied to a portion of the gain (for pass-through targets) 	<ul style="list-style-type: none"> • No step-up in asset basis unless pass-through or S corp target (with 338(h)(10) or 336(e) election) <ul style="list-style-type: none"> • If rollover, consider pre-transaction “F” reorganization alternative • Sellers may seek “tax gross-up” to cover incremental taxes due to a 338(h)(10) election or similar structure • Inherit target tax attributes (for C corp targets) and audit risk • Subject to certain limitations, Buyer acquires benefit of Target’s NOLs (for C corp targets) 	<ul style="list-style-type: none"> • Potentially two levels of tax for Seller (for C corp targets) <ul style="list-style-type: none"> • Some potential alternatives to mitigate, including sales of personal goodwill • Potential ordinary income tax rates applied to a portion of the gain (for pass-through targets) 	<ul style="list-style-type: none"> • Asset basis step-up • Amortization deductions (intangibles amortized over 15 years) • Some entity liabilities may remain (sales, property, employment taxes) • Anti-churning rules where Target is a pre-Aug. 1993 business and material (>20%) rollover equity involved

FINANCING STRUCTURES

Leveraged Buyout Financing Typical Structure



*There is often one or more holding companies between the Sponsor and the HoldCo—this may be done for tax reasons or to create a “clean” investment vehicle that is separate from the credit (and to provide flexibility for TopCo debt). Management incentive equity is often issued at TopCo.

ADDITIONAL TAX CONSIDERATIONS

- Net Operating Losses (“NOLs”)
 - Consider viability of post-closing realization
- Transaction Tax Benefits
 - Upfront adjustment to the purchase price
 - No more carrybacks of NOLs due to tax reform change
 - Carryforward of transaction related NOLs now indefinite under tax reform (but limited to 80% of taxable income)
- Pre-Closing Tax Indemnities
 - All Taxes vs. only Income Taxes
 - Baskets, caps and time limits
 - Post-Closing limitations

WHAT STRUCTURAL ELEMENTS ARE PARTICULARLY IMPORTANT TO PRIVATE COMPANY SELLERS?

- Disproportionate Allocation of Forms and Amounts Consideration
 - Forms of consideration (cash/rollover equity)
 - Amounts of consideration (i.e., non-pro rata)
 - Use of personal goodwill
- Maximizing long-term capital gains
- Transaction consideration for non-owners
 - Profits interest planning
- Estate planning considerations
- Perception of being paid for tax attributes

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

ROLLOVERS – TAX ASPECTS

- Sellers often insist on structuring the rollover as tax-deferred in order to maximize their cash return
 - Sellers may face a liquidity issue when the rollover is taxable
 - Step up in tax basis is reduced by the extent of tax deferral on the rollover
- Section 351 – rollover into a corporation
 - Must satisfy 80% control group requirement, which is difficult for add-ons funded with debt
- Section 721 – rollover into a partnership
 - Equity issued in exchange for target equity is tax-deferred, regardless of whether any other equity contributions are made
 - LP parent on top of a buyer corporation to facilitate future rollovers

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

STOCK OPTIONS

- Option to purchase shares of stock at a fixed exercise price at some point in the future based on vesting over time or achievement of performance targets
- Strike Price at Fair Market Value (or higher), otherwise will not be exempt from 409A
- Favorable tax treatment to Company
 - Unlikely to receive long-term capital gains treatment for Employee
 - Less advantageous with lower corporate rates
- Typically paid out at time of Private Equity Fund exit

PROFITS INTERESTS

- Typical to see profits interests in a limited liability company/partnership
- Value of company is shared by profits interest holders above a set threshold
- If issued at closing of acquisition transaction, threshold for sharing is contributed capital plus preferred return (if any) (may have multiple hurdles)
- Incentivizes performance like options but in a pass-through company tax structure
- Typically not taxable at time of grant because no “value”, but may make protective 83(b) election
- Profits interest holders are considered partners or members from day 1
 - Status as partner or member will have employment tax and employee benefits consequences (e.g. can’t be a member and also a W-2 employee)
 - May have phantom income allocations → consider tax distributions

STRUCTURE CONSIDERATIONS FOR OWNING PASS-THROUGH BUSINESSES—ALLOCATIONS

- Difference between distributions and allocations
 - Profits and Losses are allocated; Cash is distributed
 - Tax distributions may be important especially for partners subordinated in the waterfall or subject to vesting/distribution hurdles since income allocated on a current basis
- Targeted v. layered allocations
 - Will the waterfall dictate economics or have the parties agreed to liquidate in accordance with capital accounts?
- Need to understand the distribution waterfall in order to understand the allocations
 - Operating distributions v. liquidating distributions
 - Rule of thumb: profits are allocated down the waterfall, losses are allocated up the waterfall
- Agreements may include an override for allocations upon a liquidation so that final capital accounts match the economic entitlements of the members

STRUCTURE CONSIDERATIONS FOR OWNING PASS-THROUGH BUSINESSES—ATTRIBUTION

- Owners of partnerships/LLCs treated as flow-throughs are attributed the activities conducted by the partnership
 - Can result in concerns for non-U.S. partner not otherwise subject to U.S. tax return filing and tax payment obligations
 - Can cause partners to be exposed to state and local tax filings wherever the partnership engages in business
- Accordingly, some partners may wish to own the partnership through a corporate “blocker”
 - Blocker is subject to U.S. tax return and payment obligations in lieu of the partners who would have otherwise owned directly
 - Blocker may be capitalized in part with debt to enable efficient distribution of cash (in the form of loan repayment) and reduction of corporate level tax through interest deductions
 - Consider exit opportunities and alternatives for blocker owners (e.g., ability to sell blocker shares vs. partnership interests held by the blocker in a sale transaction, merger or other efficient disposition of blocker in an IPO, etc.)

A BRIEF SUMMARY OF CERTAIN TAX REFORM PROPOSALS

- **Corporate Rates** → increase from 21% to 26.5% effective 1/1/22
- **Individual Rates** → increases from 37% to 39.6% effective 1/1/22
- **Long-term capital gains/qualified dividends** → increases from 20% to 25%
 - Effective for taxable years ending after 9/13/21 (with transition rules for the 2021 straddle year)
 - Binding agreement exception (for agreements entered into on or before 9/13/21?)
- **New 3% surtax** for those earning more than \$5 million effective 1/1/22
- **3.8% net investment income tax** → expanded to cover income derived in an active trade or business of a pass-through entity which is not currently subject to FICA tax (e.g., S corporations and limited partnerships)
- **Carried Interest Holding Periods** → generally extended from 3 to 5 years effective 1/1/22
 - Existing 3-year holding period remains for real property trades or businesses and taxpayers with an AGI < \$400,000

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:
Maximize price Quick closing Minimal risk of not Closing Sail off into the sunset	Exclusivity Time and process to obtain financing Minimal exposure if they fail to close Minimal assumption of risk Indemnification (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...

Cash Consideration		Payoff/Assumption of Indebtedness	
Working Capital Adjustment	Escrow Amount	Seller Note	
Rollover Equity		Earnout	

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

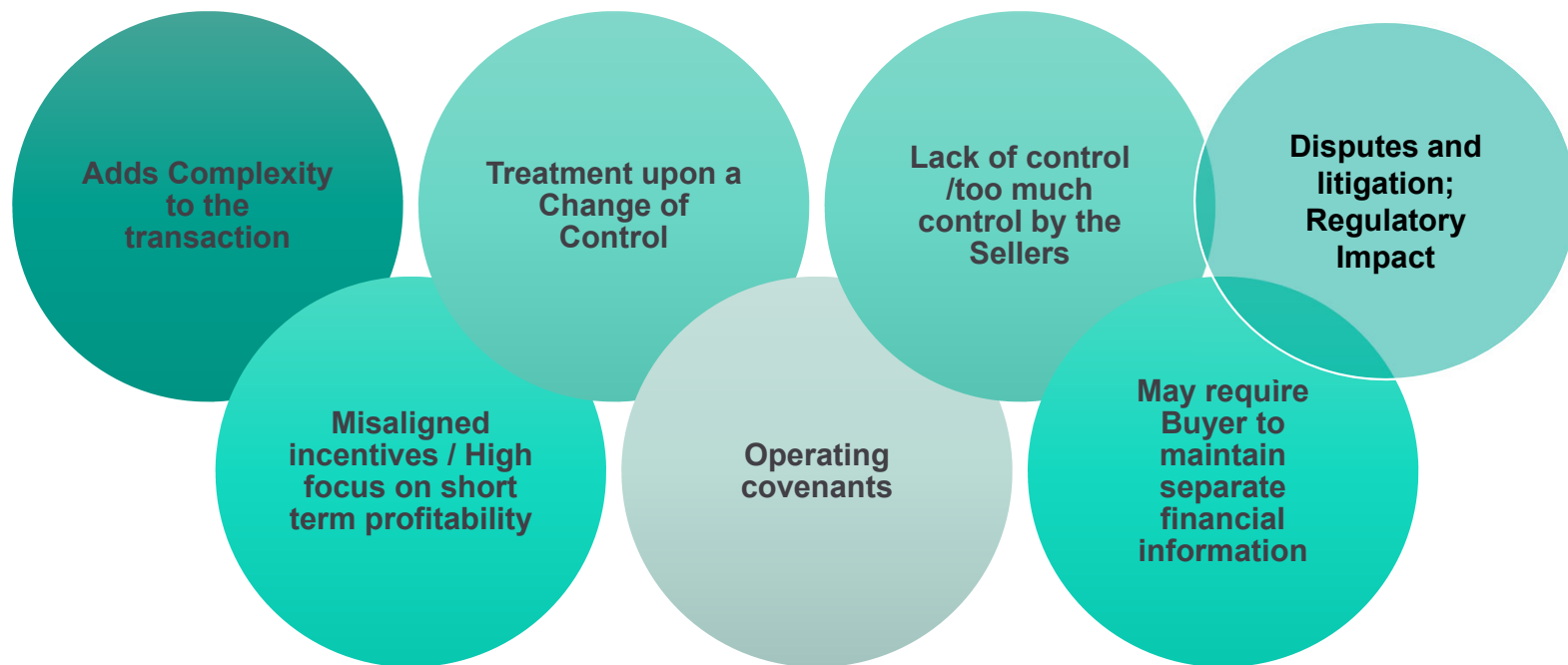
EARNOUTS...WHAT ARE THEY?

- **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)

FINANCING ISSUES IN ACQUISITION AGREEMENT

- **Primary issue:** Allocation of risk between Buyer and Seller if financing fails to materialize between signing and closing
- **Financing provisions** in Agreement may include:
 - Buyer's representation to Seller concerning the terms of its committed debt financing and/or equity financing
 - Covenant of Buyer to obtain financing prior to Closing
 - Covenant of Seller to cooperate with Buyer in obtaining financing
 - Financing condition to Buyer's obligation to close (and alternative provisions, such as reverse breakup fee)

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

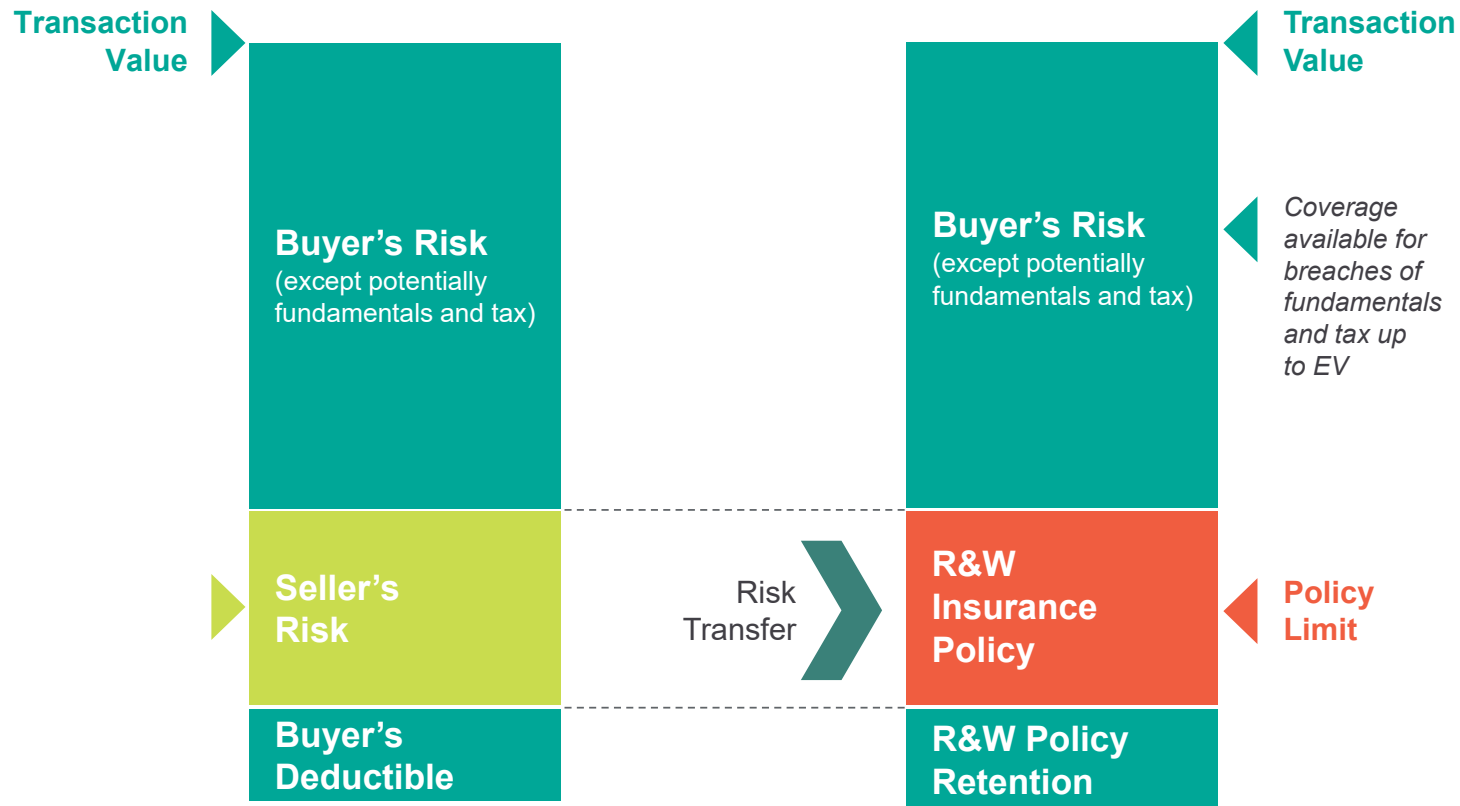


REPRESENTATION AND WARRANTY INSURANCE

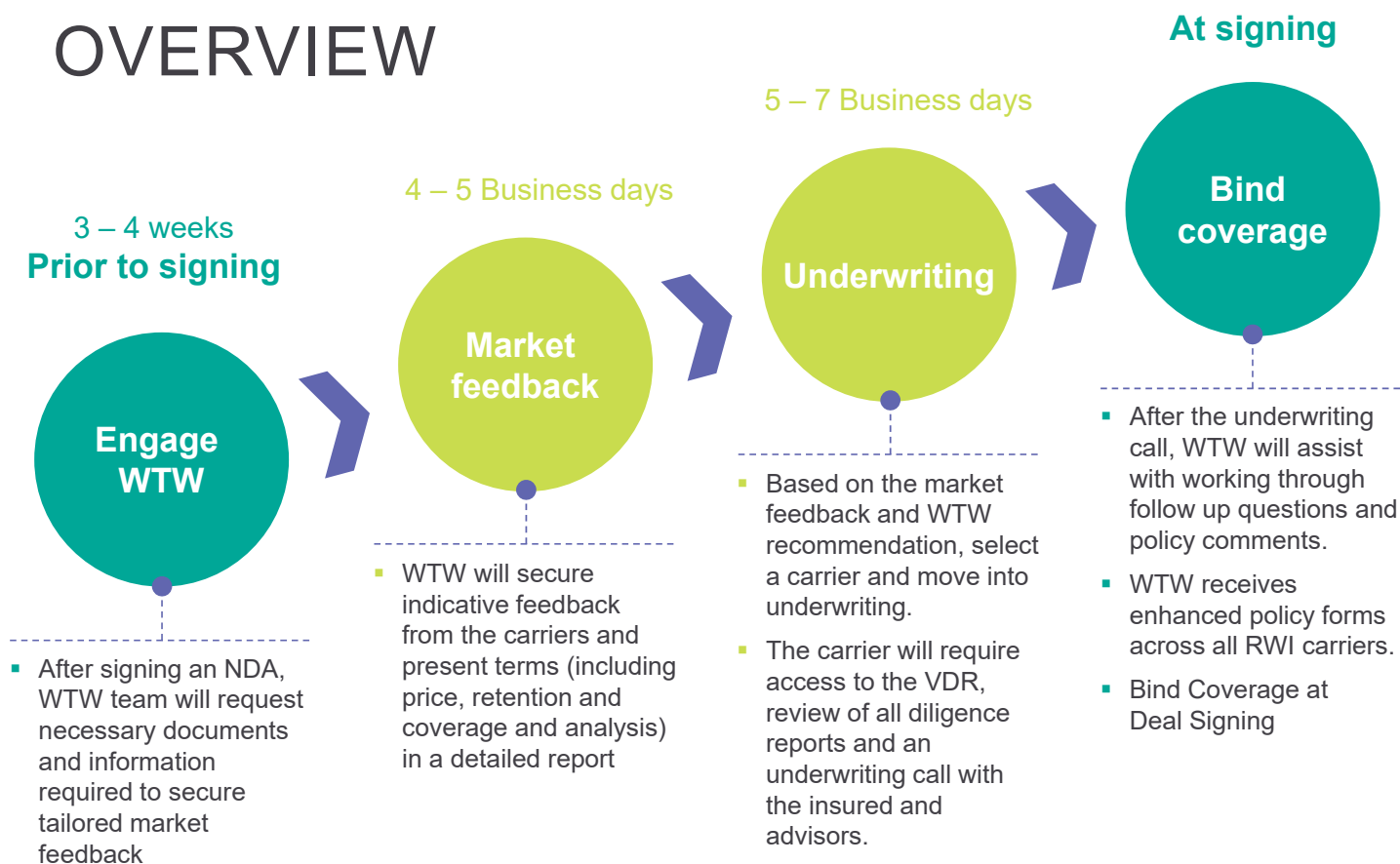
Benefits and Uses

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

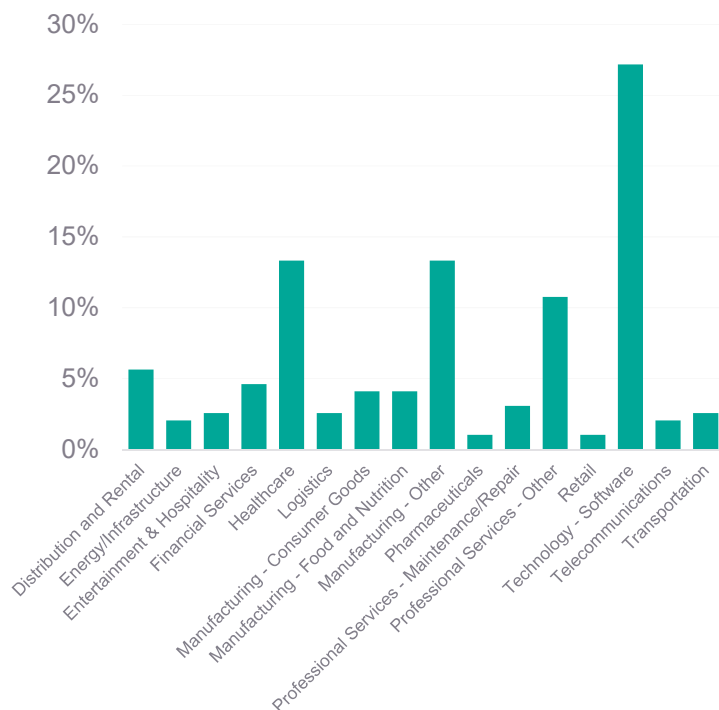
RWI insurance	
Term	<ul style="list-style-type: none">▪ 3 years for General Reps▪ 6 years for Fundamental reps▪ Coverage for 6 years for all reps may be available depending on the deal characteristics
Limit	<ul style="list-style-type: none">▪ Insureds select the coverage limit amount according to preference and risk appetite▪ Coverage available for excess fundamentals and tax risk
Retention	<ul style="list-style-type: none">▪ 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	<ul style="list-style-type: none">▪ Buyer-side policies cover seller fraud (the definition of fraud is reviewed by underwriters), so long as the insurer maintains subrogation's rights

OVERVIEW: BUYER-SIDE COVERAGE

RWI insurance	
Standard Exclusions	<ul style="list-style-type: none">▪ (a) Breaches known to the buyer's internal deal team prior to binding coverage; (b) defined benefit and retirement plan un/underfunding liability; (c) asbestos and PCBs; (d) fines and penalties uninsurable by law; (e) amount, validity, or usability of tax attributes (for example, net operating losses); (f) purchase price/working capital/leakage adjustments; and (g) transfer pricing matters.
Damages	<ul style="list-style-type: none">▪ Insurers will generally remove exclusions for consequential and multiplied damages provided that the transaction agreement neither expressly grants nor expressly prohibits such damages (i.e., is silent).
Rollover	<ul style="list-style-type: none">▪ If a seller is retaining 35% - 49% of a business, a seller NCD is required▪ If a seller retains greater than 50%, Loss is prorated according to the buyer ownership.
Interim Breach	<ul style="list-style-type: none">▪ Coverage typically incepts at signing and is brought down at Closing with no extra cost or requirements if the interim period is less than 120 days▪ In limited circumstances, an insurer may consider erosion of the retention for interim breach coverage but heavily dependent on deal characteristics (including the size of the initial retention in terms of absolute dollars)

RWI USE BY INDUSTRY CLASS

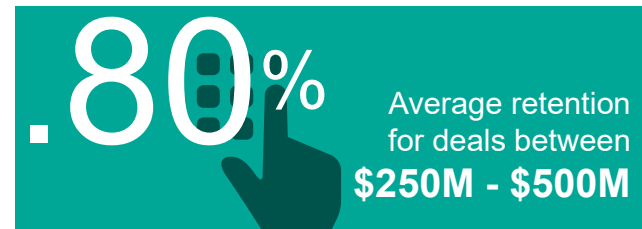
- RWI is available across all industry classes



- RWI is available across all industry sectors though certain sectors may require tailored diligence to secure RWI or may face limited appetite from the market (i.e. healthcare and financial institutions as examples)
- Our WTW team will advise clients on the unique requirements and challenges at the outset based on our market knowledge and historical experience.

2021 MARKET OVERVIEW

- Key Data on the 2021 Market



FALL 2021 MARKET TRENDS

- Our team closely tracks market trends to better advise our clients

	Trend
Healthcare	<ul style="list-style-type: none">▪ Carriers pullback from healthcare transactions (response to claims and bandwidth)▪ 5 or fewer markets (depending on the risk) will consider healthcare▪ Average RoL at least 15% - 20% higher depending on industry and risk
Cyber/ Data privacy	<ul style="list-style-type: none">▪ Carriers are increasingly focused on the availability of underlying cyber coverage across all deals▪ Carriers increasingly taking an "Excess of and No broader than" position at the outset
Deal size	<ul style="list-style-type: none">▪ Reduced appetite for deals with EV lower than \$75M▪ The availability of audited financials is a key factor
Deal structure	<ul style="list-style-type: none">▪ Market Pullback on Carve-Out Transactions▪ (Reaction to financial statements claims)▪ Pre-Exclusivity Feeds above \$100,000 on average with limited market appetite

NEW HORIZONS FOR TRANSACTIONAL RISK

- Transactional insurance continues to evolve to meet client needs



Take private transactions

- WTW has placed RWI on multiple take private transactions.
- Primary obstacle is to scrape materiality/MAE qualifiers on public style MAE qualified reps.
- One insurer concern has been the lack of a true “seller” to pursue in event of fraud.



Cross border transactions

- WTW’s global team has placed cross-border policies involving multiple jurisdictions and international Named Insureds
- Insurers are building out underwriting expertise in more regions, which offers greater flexibility



Unique structures

- Fund to Fund
- Secondaries Transactions
- Distressed Transactions

OVERVIEW OF RWI CLAIMS

High level claims overview

Frequency

- 1 out of every 5 policies results in a claims notice (i.e. a notice but not necessarily a payment)

Notification

- > 60% of claims made within the first 12 months (See [AIG Claims Study](#))

Common breaches

- Financial Statements and Tax matters remain the most frequent source of claims
- Claims based on 'Compliance with Laws' and 'Material Customer/Supplier' Breaches are increasing

Impact

- Our team considers claims history and handling as a critical factor when considering our recommendations to clients

WILLIS TOWERS WATSON CLAIMS

- Willis Towers Watson supports our clients through the lifecycle of a policy

Our claims team

- Willis Towers Watson's North American Claims team consists of 18 claims specialists including dedicated transactional risk claims advocates who work closely with our clients guiding them through the initial stages of a process and through the satisfactory resolution of claims payment.
- The placement transactional risk broker will remain actively involved and involved a direct point of contact.
- Our Willis Towers Watson claims team has handled hundreds of claims and routinely maximizes the insurance proceeds payable to our clients.
- On a global basis, we have recovered over \$6.5 billion in claims proceeds.

TAX INSURANCE

Tax insurance solutions

- **Provides certainty by removing potential tax risk**
 - Purchase-price certainty in connection with an acquisition
 - Tax results certainty in connection with any business restructuring or other tax planning
 - Tax benefit certainty (e.g., in relation to quality and quantity of NOLs, available tax credits and depreciable basis)
 - Compliance certainty in connection with tax return filings (e.g., corporate, partnership and amended tax returns)
- **Protects against liquidity impact arising from a tax assessment**
- **Facilitates equity and debt infusions by removing tax uncertainty**
- **Enables tax planning to move forward without financial statement impact for an uncertain tax position**
- **Facilitates balance sheet management** (e.g., to meet debt/ equity ratio under credit agt.)
- **Enables distribution or utilization of cash** (including cash generated from tax refunds) that would otherwise need to be held in reserve to cover potential tax claims or challenges by a taxing authority

POTENTIAL INSURABLE TAX RISKS

- Policies are tailored to the specific transaction and risk

Qualification/ Elections

- S corp., REIT, ESBT, QSST status; 336(e)/338(h)(10) elections; 83(b) elections, check-the-box elections; 1202 QSBS; 401(a) retirement plan qualification

Characterization/ Classification

- Cryptocurrency transactions; Debt/Equity; Dividend/Interest; Ordinary/Capital; USRPHC status; CFC status; Employee/IC status; Carried interests

Deductions/Losses

- Bad debt; Worthless stock; NOLs; 382/384 limitations

Reorganization/ Deferral

- Tax Treatment of spinoff, merger, liquidation, incorporation; 1031 Exchange

Computation/Valuation

- Basis; Insolvency/COD income; E&P; NOLs; GILTI and Subpart F inclusions; Transition tax; 280G parachute payments; Appraisal

Transfer Pricing/ Cost Segregation

- Compliance/Documentation; Cost sharing/licensing; Cost segregation studies

Tax Credits

- Renewables (ITC/PTC); Carbon capture credit; Employee retention credit; Rehabilitation tax credit; Foreign tax credits; State tax credits

Non-US Tax Matters

- VAT; PE status; Treaty qualification; Withholding; Portfolio interest exemption

State, Local & Other Tax Matters

- Sales/Use tax; Real property transfer tax; Estate and gift tax matters; Tax refund claims

MARKET OVERVIEW

Marketplace for Tax Insurance

Well-developed

- Insurance companies and MGUs continue to invest in tax underwriting capabilities as brokers and underwriters continue to develop insurance solutions for an array of tax issues that render the product more agile and useful to clients.

Growing

- New entrants in the tax market driving competition leading to broader coverage for insureds and more favorable pricing.
 - 14 primary U.S. markets in 2021
 - Excess markets as needed

Capacity

- In excess of **~\$1 billion** in coverage limits available, per transaction

Insurers

- AIG, Ambridge, ASQ, Berkley Pro, Berkshire Hathaway, BlueChip, Concord, Ethos, Euclid, Everest, Great American, Liberty, QBE and Vale**

KEY LEGAL DOCUMENTS REVIEW



OTHER KEY LEGAL DOCUMENTS

- **Stockholder Agreements (or LLC Agreement)**
- **Credit Agreements**
- **Employment Agreements**
- **Restrictive Covenant Agreements**
- **Escrow Agreements**

STOCKHOLDERS AGREEMENT (OR LLC AGREEMENT)

- Typically used in an equity transaction and/or rollover equity concept.
- Provides governance principles for ongoing relationship of equityholders.
- Common Provisions:
 - Transfer Restrictions
 - Preemptive Rights
 - Board Rights
 - Restrictive Covenants
 - “Drag and Tag”

CREDIT AGREEMENT

- Dual Workstream with Purchase Agreement
- Equity Commitment Letters / Debt Commitment Letters
- Impact on Purchase Agreement:
 - Allocation of risk if financing fails
 - Representations / Covenants made by Buyer
 - Covenant of the Seller to cooperate with the Buyer in obtaining financing
 - Financing condition to the Buyer's obligation to close (and alternative provisions, such as reverse breakup fee)
 - Xerox Provisions
- Coordination with Lender on review of Purchase Agreement

EMPLOYMENT AGREEMENT

- Often used to retain key personnel at Target.
- Specific to industry, compensation arrangement, and importance to transaction.
- Key Provisions
 - Termination of Employment
 - Cause / Good Reason / Death/Disability
 - Non-compete and Non-solicit
 - Compensation
 - Equity
- In certain situations, use of historic/existing agreements can expedite process if agreeable to parties.

RESTRICTIVE COVENANTS AGREEMENT

- Purpose is to secure agreement from certain individuals that he/she/it will not compete using retained knowledge of sold business or interfere with customer relationships/employees
- Sale of business vs. employment agreement vs. Stockholder/LLC Agreement
- Key Terms
 - Length of Time
 - Definition of “Business”
 - Applicable Area
 - Non-compete/Non-disclosure Requirements
 - Reminder to check certain state laws (e.g. CA, TX)

ESCROW AGREEMENT

- Typically provides sources of funds for:
 - Purchase Price Adjustments
 - Indemnification Claims
 - Specific Indemnities
- Form dependent on Escrow Agent
- Distribution Provisions – Sync with Purchase Agreement
- Payment of Fees
- Interest/Income Reporting
- KYC Timing

RECENT TRENDS

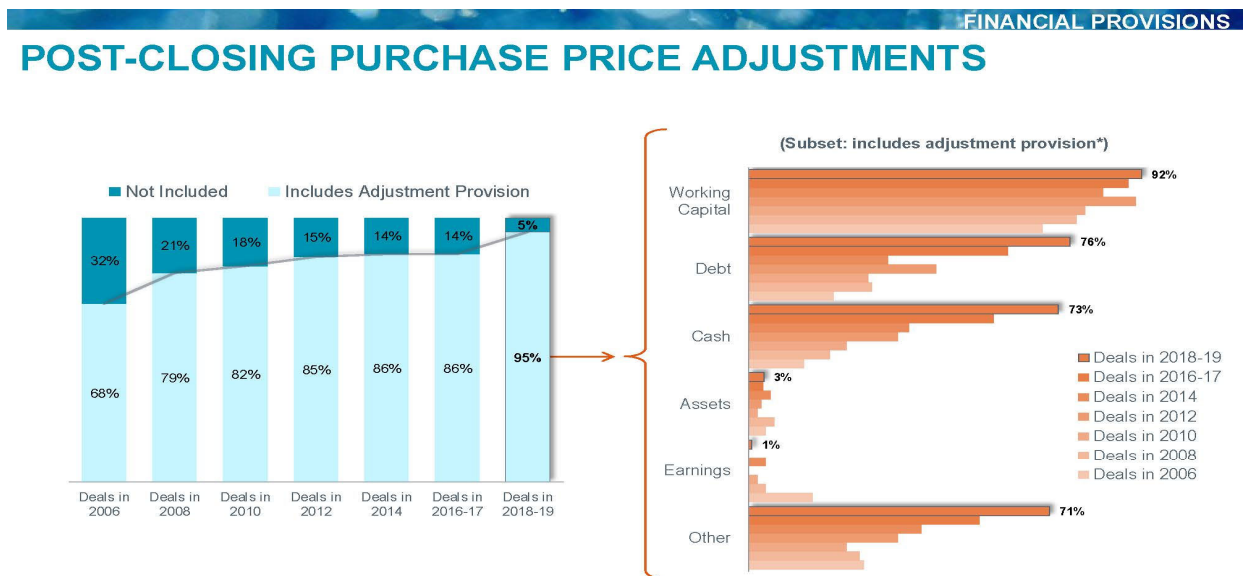


RECENT TRENDS (PPP LOANS)

- Forgivable loans provided by US Small Business Administration “SBA”
- SBA Guidance – Consent
 - Triggers differ by type of transaction
 - Loan thresholds
- Separate Escrow?
- Timing

RECENT TRENDS (PURCHASE PRICE ADJUSTMENT)

- Nearly universal
- Estimate at Closing
- Top Exclusions:
 - Debt/Net Debt
 - Cash/Cash Equivalents
 - Transaction Expenses
- Separate Escrow – Split



* 87% of the post-closing purchase price adjustments were based on more than one metric.

M&A Market Trends Subcommittee, Mergers & Acquisitions Committee, https://www.americanbar.org/groups/business_law/committees/ma/deal_points/

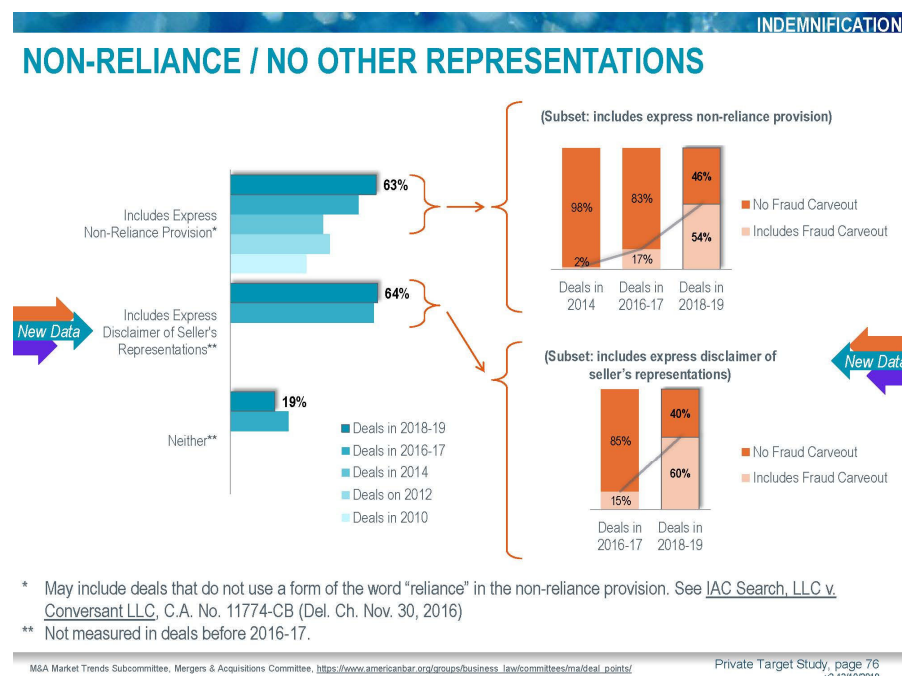
Private Target Study, page 12
v2 12/10/2019

RECENT TRENDS (#METOO; PRIVACY)

- Rise in the inclusion of certain representations
- #MeToo – Knowledge qualified?
- Privacy and Cybersecurity – Hot Topics
 - Typically inclusive of more than specific area (e.g. medical records)
 - Broader than “compliance with laws”

RECENT TRENDS (NON-RELIANCE)

- Limited to reps provided by Target
- Disclaimer of no other reps other than those provide by Target
- Fraud



QUESTIONS?



THANK YOU.

