



# HEALTHCARE PRIVATE EQUITY ASSOCIATION 101: LEGAL CONSIDERATIONS

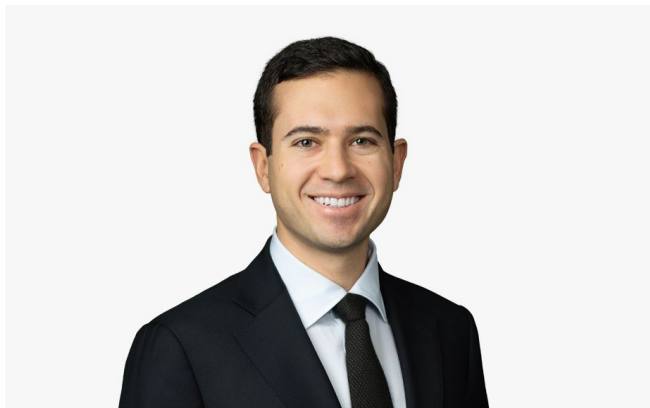
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Nate focuses his practice on mergers, acquisitions and divestitures, and private equity and strategic investments. He represents strategic and private equity buyers and sellers across a wide range of industries. Nate also regularly counsels private and public companies in connection with corporate governance matters and federal securities law matters.

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Smith focuses his practice on representing private equity sponsors and their portfolio companies as well as other private companies in complex business transactions, including mergers, acquisitions and divestitures, leveraged buyouts, cross-border transactions, corporate carve-outs, joint ventures, minority investments, financings, reorganizations and complex corporate governance matters.

Smith also provides clients with day-to-day general corporate advice and counsel on business operations, including employment matters, equity compensation, commercial contracts and confidentiality agreements.

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# ANATOMY OF A PURCHASE AGREEMENT

- Purpose of the Purchase Agreement
- Purchase Agreement Overview
- Purchase Agreement Structure
  - Stock Purchase v. Asset Purchase v. Merger
  - Bifurcated v. Simultaneous Sign and Close
- Purchase Price
  - Adjustments
  - Earnouts
- Representations and Warranties
- Closing Conditions / Termination
- Covenants
- Indemnification
- R&W Insurance

# PURPOSE OF THE PURCHASE AGREEMENT

- **Sellers want:**

- Best price
- Quick closing and certainty of closing / consummating the deal
- Minimal continuing obligations and risk (read: buy that yacht and sail off into the sunset)

- **Buyers want (Inverse!):**

- 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 OVERVIEW

- Preamble; Recitals
- Definitions
- Purchase and Sale; Purchase Price
- Reps and Warranties
- Covenants and Additional Agreements
- Closing and Closing Conditions
- Indemnification
- Termination
- Miscellaneous
- Disclosure Schedules and Exhibits

# PURCHASE AGREEMENT STRUCTURE

- Asset v. Stock v. Merger
- Considerations:
  - Tax
  - Liabilities
  - Number of equityholders
  - Seller type / necessary approvals
  - Timing
  - Costs
- Auction Process
  - Competitive process, so generally more “middle of the road”
  - More standard R&W, knowledge qualifiers, RWI
  - Full mark-up of purchase agreement vs. partial mark-up (i.e., bid memo or mark-up of only corporate reps with footnotes that specialist comments are forthcoming)

# BIFURCATED VS. SIMULTANEOUS SIGN AND CLOSE

## Simultaneous

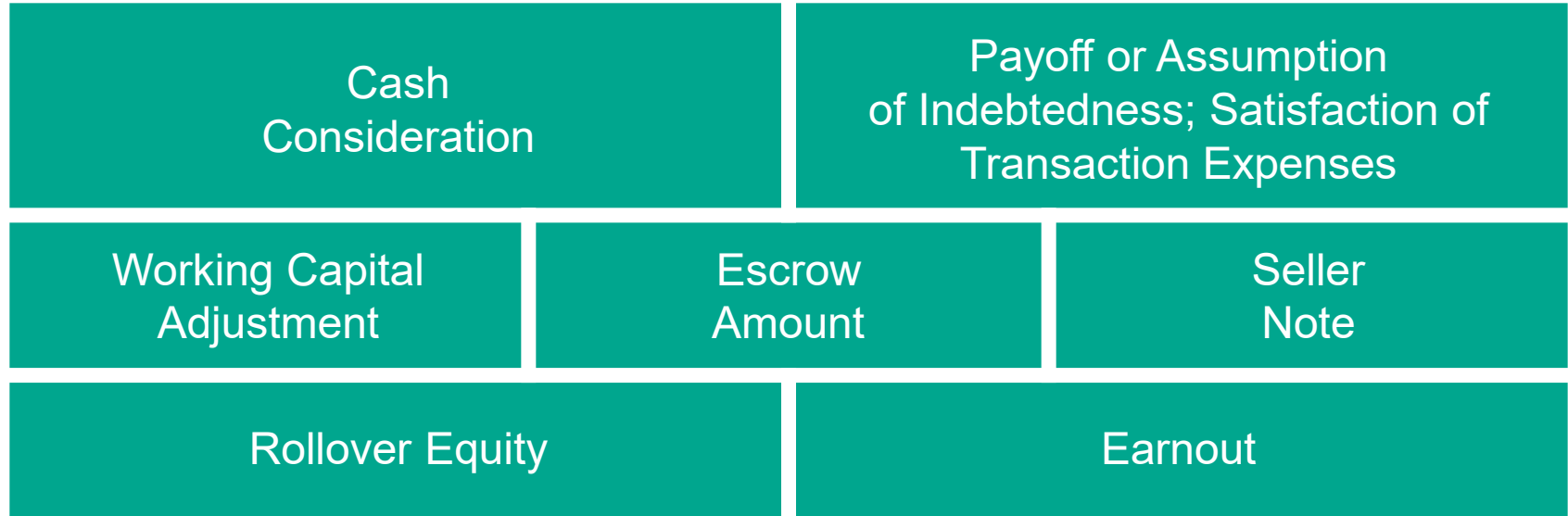
- Simpler process, but no one is bound to terms
- Certain highly negotiated purchase agreement provisions are unnecessary (e.g., pre-closing covenants, closing conditions, termination)

## Bifurcated

- May be required for regulatory reasons (government approvals – e.g., antitrust, energy, healthcare, insurance, etc.)
- Buyer may prefer to raise financing after signing the Agreement
- Buyer may want certain consents prior to closing
- Negotiations/documentation more complex & Target must comply with operational and other covenants during interim pre-closing period

# ELEMENTS OF THE 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 pre-closing estimates and post-closing **actuals**
  - Purchase price is:
    - **↑** by cash of the Target at closing
    - **↓** by debt of the Target at closing
    - **↓** by Target / seller transaction expenses at closing
    - **↑** or **↓** by working capital of the Target at closing in relation to agreed upon working capital target

# PURCHASE PRICE ADJUSTMENTS

- **Working Capital**

- Current Assets of the Target **less** Current Liabilities of the Target (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 Target's prior practices?)
- Parties agree on a working capital target or band, and the purchase price is adjusted up or down based on the difference between the actual amount at closing 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 and other “debt-like” items

- **Transaction Expenses**

- Include any advisor/counsel fees and transaction bonuses being paid out in connection with the transaction

# EARNOUTS – WHAT ARE THEY?

- **A tool to bridge the valuation gap** in the negotiation of the final Purchase Price
- **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
- **Pros:** decreases risk of over-valuation, ensures incentive to stay and grow the company, reduces upfront payment
- **Cons:** may restrict Buyer’s operation of the business, lack of control for Sellers, difficult to track, motivates Seller to maximize earnout, could affect outside financing

# REPRESENTATIONS AND WARRANTIES

## Reps & Warranties

A series of factual statements and promises regarding (i) the parties, (ii) the transaction, and (iii) the condition, nature and scope of the business being acquired

## Disclosure Schedules

A disclosure schedule is a list attached to an agreement setting forth exceptions to (or affirmative lists of) the factual statements and promises made by a party in the purchase agreement

***Together, the Reps and Warranties and the Disclosure Schedules provide the factual statements made by (or on behalf of) Target regarding the business***

# INCORPORATING DILIGENCE RESULTS INTO CERTAIN ASPECTS OF THE PURCHASE AGREEMENT

## Reps & Warranties

- Adjust scope of reps and warranties based on nature of the business and diligence findings.
- **For example:**
  - More expansive real estate representation in a business where real estate is of particular importance
  - More aggressive inventory and accounts receivable reps in a business where inventory and A/R account for a large percentage of the Target's assets
  - Specific reps and warranties regarding largest customers for a business that has high customer concentration

## Disclosure Schedules

- Reveal additional information that potentially impacts negotiation of reps, warranties and covenants
- Disclose findings that are inconsistent with diligence findings
- Impact indemnification rights
- Avoid “kitchen sink” disclosures

# CLOSING CONDITIONS

***Closing conditions are commonly negotiated and can include...***

Consent under certain contracts or permits

Employment agreements/incentive equity plan

Delivery of other key agreements, like RCAs

Regulatory approvals  
(e.g., HSR)

Customer calls

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

# TERMINATION

- **Bifurcated signing/closing (delayed closing)**
  - Sets forth when the agreement can be terminated (e.g., drop dead dates, breaches of closing conditions, absence of financing following a marketing period, failure to receive regulatory approvals)
- **Implications of Termination**
  - What provisions survive (including indemnification obligations)
  - Reverse termination fees/breakup fees

# KEY COVENANTS – BY THE SELLER

Pre-closing operation of the business / Interim Operating Covenants	Non-solicit (employee and customer) and no-hire
General release	Obtain stockholder consent
Non-compete	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)
- No indemnification is available for public deals
- ***Who does it apply to?***

**Buyers. Sellers. And sometimes parent entities...**

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

## **Who is really at risk? Sellers**

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

## **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... BREACHES OF REPRESENTATIONS AND WARRANTIES

- **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, 2021, the Company received notice that certain of its employees made illegal payments to zoning officials in connection with 6 distribution centers located in Mexico.”*

## What’s the deal with Disclosure Schedules?

Since disclosures modify the applicable representations and warranties, if a liability is disclosed then there would be no breach and thus no indemnification.

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

Beware of the overly broad, kitchen sink disclosure.

# LIMITATION ON INDEMNIFICATIONS

*Parties will negotiate 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

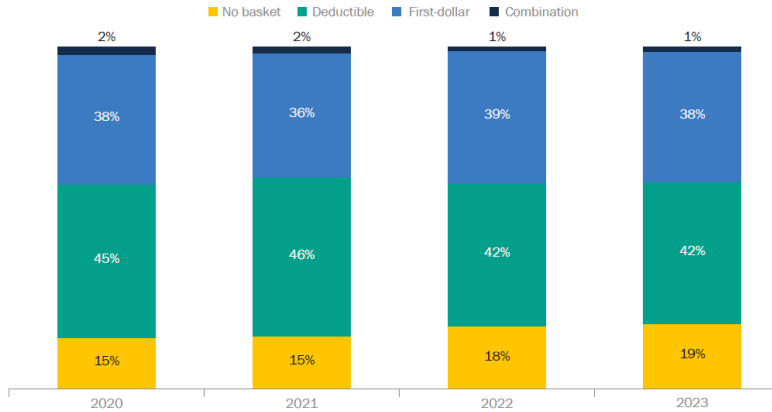
Sand Bagging

# DOLLAR LIMITATIONS

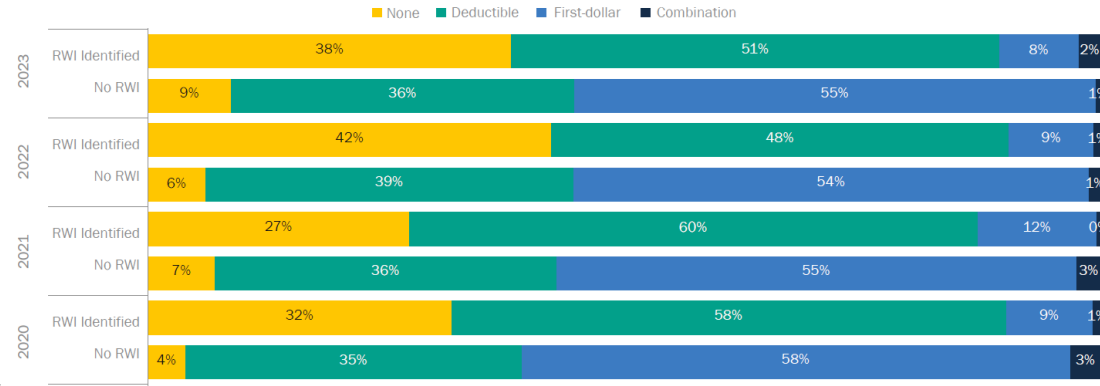
Deductible	“First dollar” threshold or “tipping basket”	“Mini Basket”
<ul style="list-style-type: none"><li>• A party need not indemnify the other for certain liabilities unless the damages exceed a minimum amount</li><li>• Party then <b>only responsible for losses exceeding the Deductible</b></li></ul>	<ul style="list-style-type: none"><li>• A party need not indemnify the other unless damages exceed a minimum amount. However...</li><li>• Once this minimum amount has been reached, the damaged party may seek indemnity for all of its damages <b>from the first dollar</b></li></ul>	<ul style="list-style-type: none"><li>• Individual losses must exceed a <i>de minimis</i> threshold to be subject to indemnification</li><li>• Works with Cap and Threshold to provide greater limitations on indemnification obligations</li><li>• Mechanism to avoid “<b>death by a thousand cuts</b>”</li></ul>

# BASKETS – WHAT’S MARKET?

BASKET FREQUENCY



BASKET TYPE DISTRIBUTION, DEALS 2020-2023

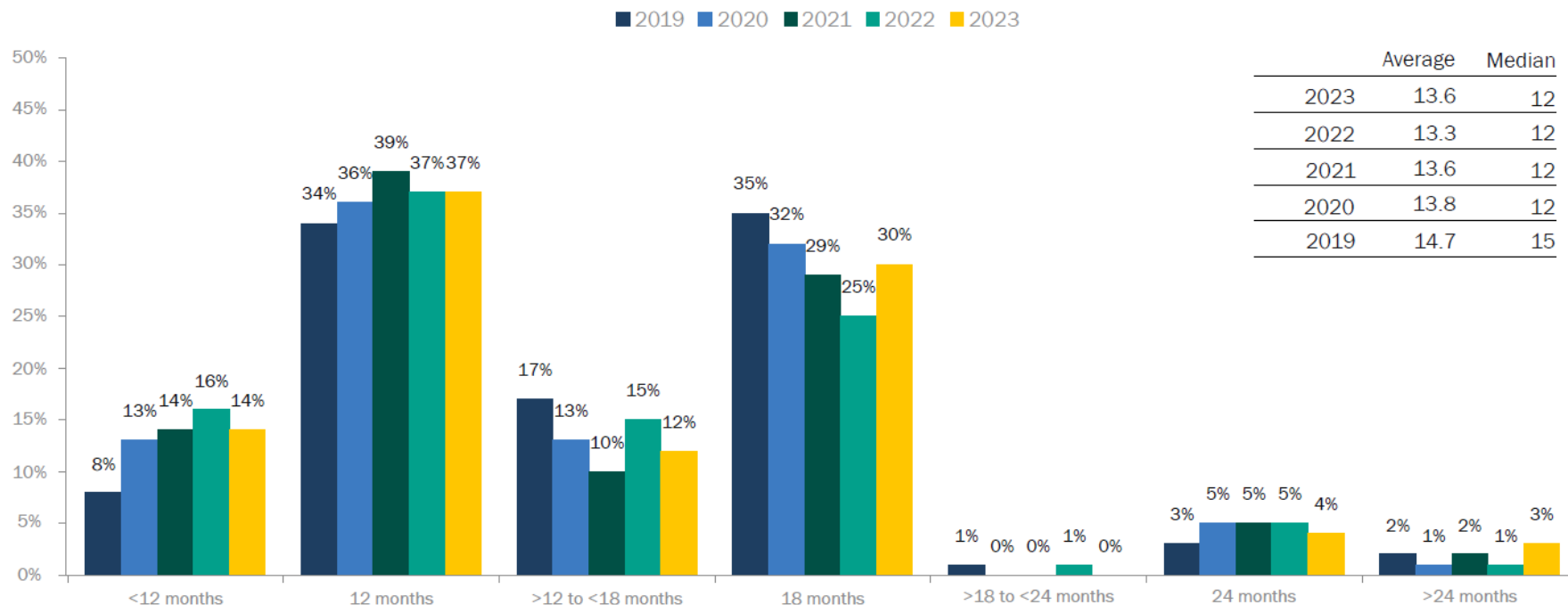


# TIME LIMITATIONS

- **Representations made by a private company Seller typically survive for an agreed period of time 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, stock ownership and brokers' fees (or title to assets in an asset deal) may survive indefinitely (aka the “fundamental” reps and warranties)

# SURVIVAL FOR GENERAL REPS – WHAT’S MARKET?

SURVIVAL PERIOD (2023 MEDIAN: 12 MONTHS)



	Average	Median
2023	13.6	12
2022	13.3	12
2021	13.6	12
2020	13.8	12
2019	14.7	15

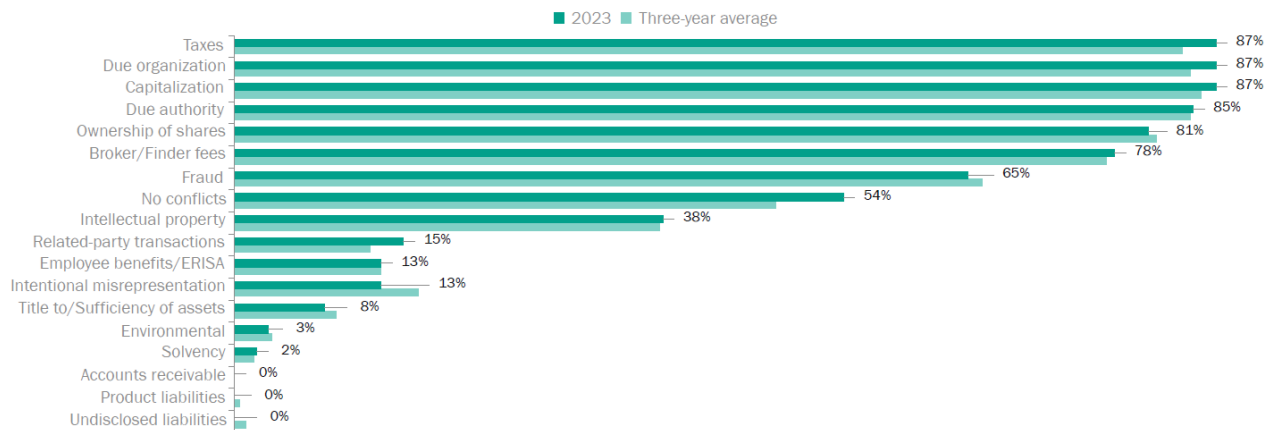
SRS Acquiom 2024 M&A Deal Terms Study



# FUNDAMENTAL REPS – WHAT’S MARKET?

## Carveouts to general survival limitation

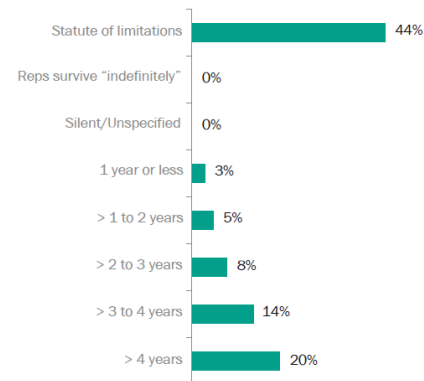
CARVEOUT FREQUENCY: 2023 DEALS COMPARED TO THE THREE-YEAR AVERAGE (2021–2023)\*



\* Matters subject to carveouts survive longer than the general survival period.

† Percentages in the chart are for 2023 deals.

GROUP OF "FUNDAMENTAL REPRESENTATIONS"



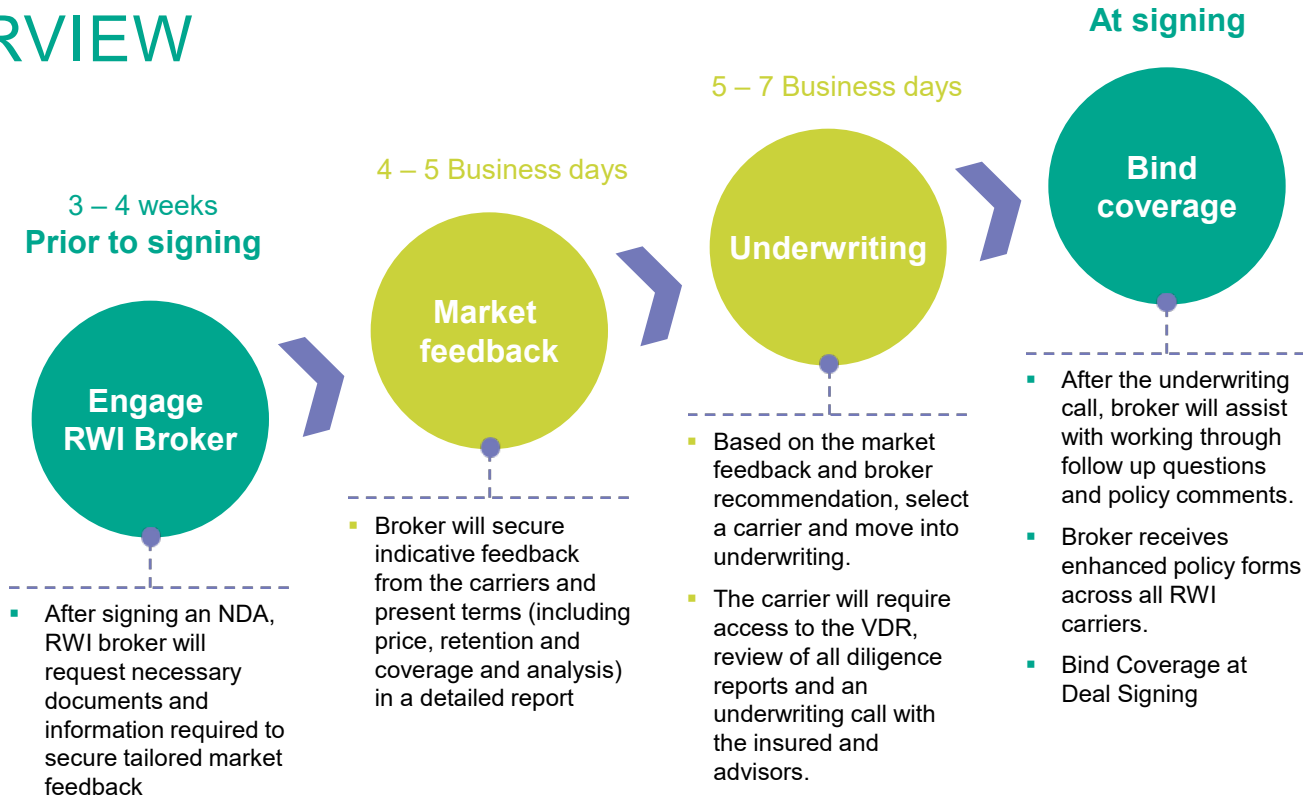
# SATISFYING OBLIGATIONS...SOURCES OF RECOVERY

- **Direct recovery from Seller**
- **Holdback from the Purchase Price (Buyer or Seller holdback)**
- **Escrow**
  - Deposit cash with a third party 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
  - Strategic buyers prefer having the escrow as a source of remedy
- **Rights of Setoff**
  - Setoff rights against seller note, earnout or other post-closing payments in favor of the Seller, or against any of Seller's rollover equity
- **Representation and Warranty Insurance** (only 46% include indemnification escrow – 2023 SRS Acquiom)

# REPRESENTATION AND WARRANTY INSURANCE – GENERAL

- **An insurance policy under which a Buyer can recover for breaches of Seller’s representations and warranties**
- Key terms and considerations:
  - Retention
  - Policy period
  - Limit
  - Premium
  - Exclusions – these vary by underwriter and are negotiable, but **all known liabilities** will be excluded from coverage
    - Sample exclusions include: HIPAA liability, FLSA liability, data privacy liability, environmental liability
  - RWI policy may read out certain materiality qualifiers and “non-standard” provisions
  - Need to discuss allocation of responsibility for losses that are excluded under the RWI policy

# RWI HIGH LEVEL PROCESS OVERVIEW



# REPRESENTATION AND WARRANTY INSURANCE – WHAT'S MARKET?

- More commonly used in PE deals, though starting to see strategics use (except in auction contexts)
- Of such deals, Buyer obtains (95%) and typically pays for the policy
- Parties will negotiate the extent to which the RWI Policy will be the sole source of recovery and who bears the risk / cost associated with specific indemnities / exclusions to the RWI Policy

# IMPORTANT COMPLIANCE CONSIDERATIONS

- The Anti-Kickback Statute (AKS):
  - Prohibits the exchange of anything of value to influence referrals for payables under a federal reimbursement program (e.g., Medicare, Medicaid, TRICARE), subject to certain exceptions
- The Physician Self-Referral Law (a/k/a the Stark Law):
  - Prohibits physicians from referring patients to entities with which the physician (or immediate family) has a financial relationship, subject to certain exceptions
- False Claims Act (FCA):
  - Imposes large civil penalties on any person who conspires to or knowingly submits false claims
  - Permits individuals to file suits on behalf of the government as “whistleblowers” (with financial incentive to do so)

# HEIGHTENED SCRUTINY OF PRIVATE EQUITY

- The growing concentration of PE-owned healthcare entities has led to increased scrutiny of PE's role in healthcare and considerable uncertainty around what deals will be subject regulatory review and how strict those processes will be
- In March 2024, the FTC, DOJ and DHHS announced a joint inquiry into PE's increased involvement in healthcare
- Legislatures in several states, including California and Massachusetts, have recently passed, or are actively considering, legislation designed to (1) introduce additional reporting requirements and/or (2) strengthen prohibitions on the corporate practice of medicine (“CPOM”)

# RESOURCES

- ABA Deal Points Study (Public and Private Targets)
- SRS M&A Deal Terms Study
- Practical Law (for almost everything!)
- SRS Life Sciences M&A Study
- SRS Buy-Side Representations and Warranties Insurance Deal Terms Study
- Aon Claims Study for R&W Insurance
- YourSource Corporate Forms
- EDGAR