

Private Equity Transactions in Healthcare: Stark, AKS, and Other Compliance Challenges

Structuring Purchase Price, Restrictive Covenants, Indemnities, Equity Rollovers, and More

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Agenda

- Purchase Price Considerations
- Deal and tax structuring
- Common deal terms and indemnities
- Restrictive Covenants
- Rollover Equity
- Covid considerations - Covid relief plans
- Regulatory and Compliance issues

Purchase Price Considerations

- What is EBITDA?
 - Base level practice EBITDA, plus
 - Restructured compensation, plus
 - Run-rate or annualization of growth initiatives, plus
 - Proforma adjustments incorporating regulatory and reimbursement changes
 - Other Considerations

Purchase Price Considerations

- Restructuring Compensation
 - Basic concept: adjust owners to employed MD comp levels
 - Relative practice ownership changes based on comp give up vs. total EBITDA
 - Tax considerations need to be understood to ensure optimal treatment
- Annualizing Growth Initiatives
 - Full year credit for new provider additions
 - Annualizing ancillary service expansion
 - New clinic location ramp up
 - Capturing leakage and getting credit

Purchase Price Considerations

- Dealing with Changes in Regs and Reimbursement
 - Annualize changes in Medicare and managed care rates
 - Annualize changes in procedure coding, e.g. bundling
 - Analyze potential for reimbursement pick up from better contracting, or other strategies like PHO management
 - Ensure proper coding – positive and negative impact
- Other Considerations Impacting EBITDA
 - Consider impact of competitive pressures and opportunities
 - Buyer synergies

Purchase Price Considerations

- Preparing to go to Market
 - Get agreement on comp restructuring and reconfigured ownership *before entering market*
 - Sell-side QofE important
 - Third-party coding audit and compliance review essential, *before engaging buyers*
 - Taxation can be tricky; deal with this early

Deal and Tax Structuring

- Corporate Practice of Medicine
 - Most states have some form of “corporate practice of medicine”
 - Influences structure
 - Generally requires the use of a “friendly” or “captive” professional entity
 - Economics captured in Management Company through management fee

Deal and Tax Structuring

- Corporate Practice of Medicine
 - New York state settlement with Aspen Dental Management
 - New York State AG alleged that ADMI did not simply provide business support and administrative services but subjected its managed dental practices to extensive “undue control”
 - New Jersey’s Allstate decision
 - Many states have some form of CPOM concept and fee-splitting prohibitions
 - **Significant risks can arise when a non-professional vendor is engaged to manage or consult** a licensed professional or an entity comprised of licensed professionals.

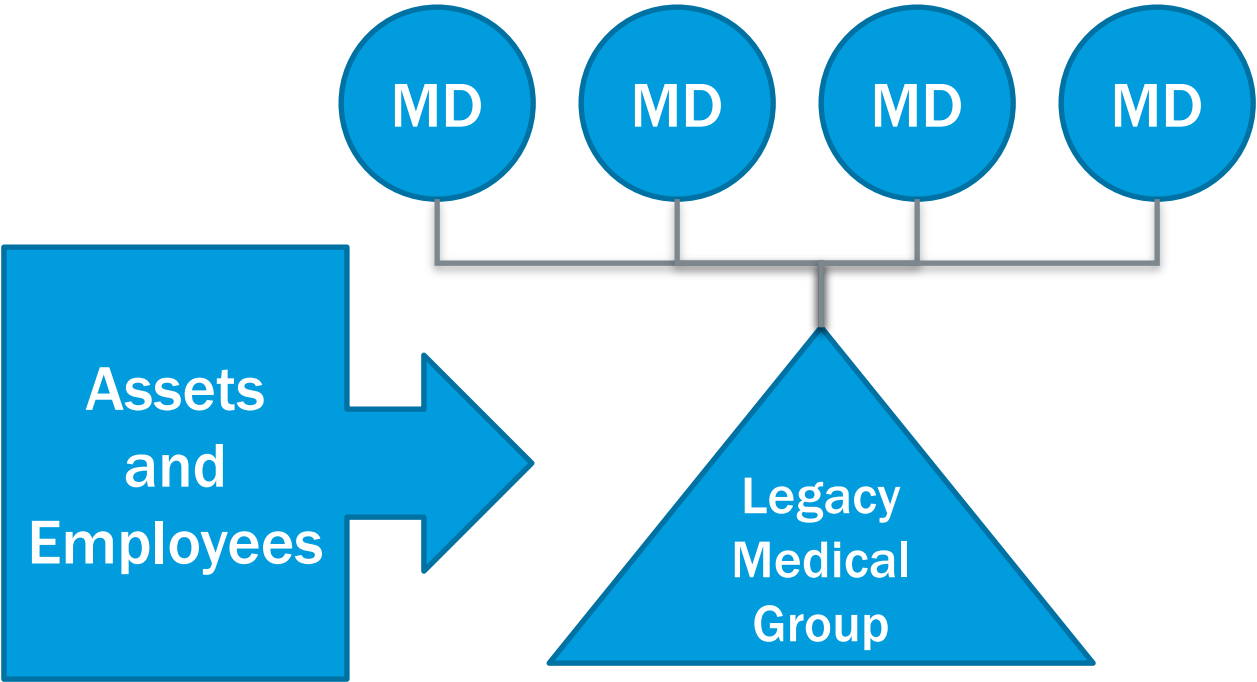
Deal and Tax Structuring

- Corporate Practice of Medicine
 - Who is really in control of the practice, not just in control of clinical decision making?
 - Can the Manager cause the friendly PC shareholder to relinquish control? If not, what other remedies are available?
 - How are management/administrative services fees determined? Are they consistent with FMV?
 - Can the manager unilaterally discipline/fire licensed professionals?
 - What do the non-competes look like?
 - What impact does a loosening of control/restrictions and renegotiation of management fees have on purchase price?

Deal and Tax Structuring

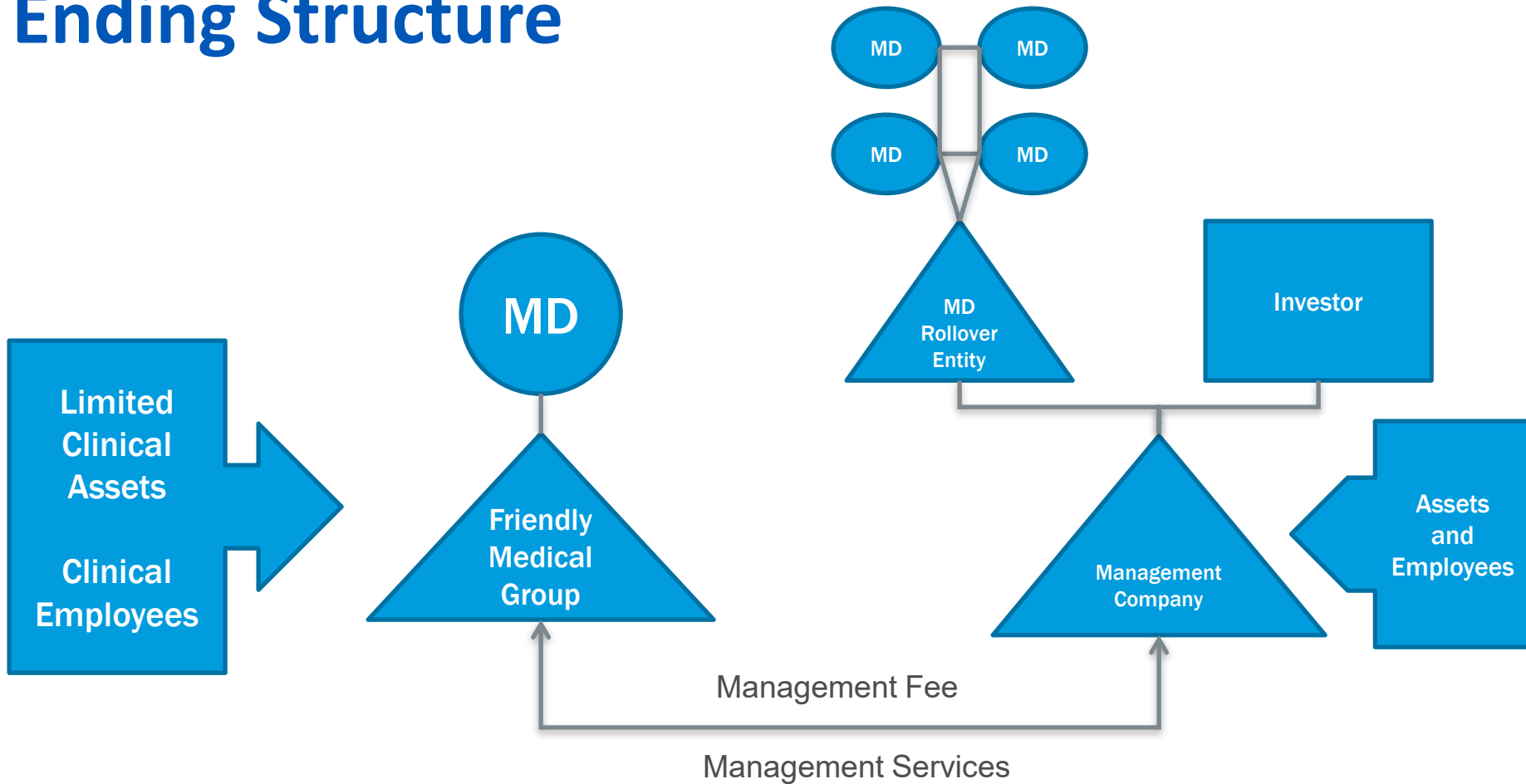
- ✦ Taxation can be tricky, and costly
- ✦ Address this early in the deal

Deal and Tax Structuring: Starting Structure



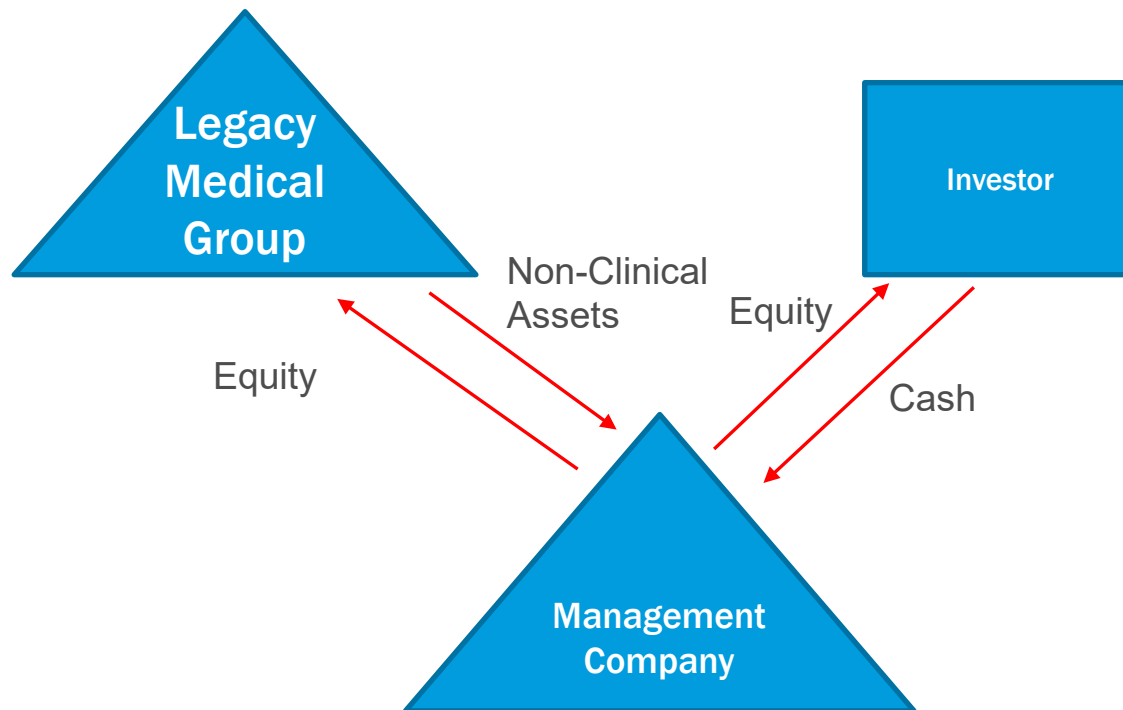
Deal and Tax Structuring

Ending Structure



Deal and Tax Structuring

Primary Intermediate Step



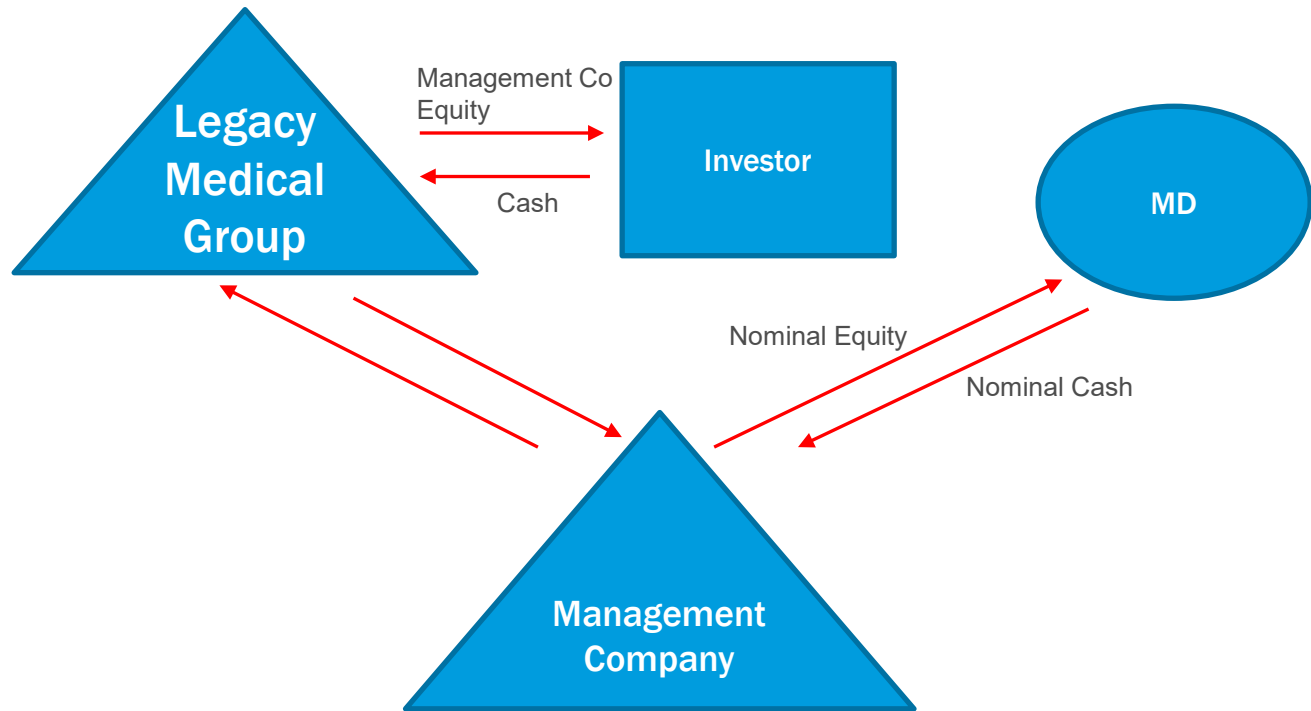
Deal and Tax Structuring

Tax Considerations

✦ Anti-churning Rules

- IRC Section 197 governs amortization deductions for intangible assets, including goodwill and going concern value.
- Before the enactment of §197 in 1993, goodwill and going concern value were treated as non-amortizable intangible assets.
- The anti-churning rules were enacted to prevent abuse where a related party would purchase the goodwill solely to create an amortizable intangible asset (i.e. “churning”).
- Assets subject to the anti-churning rules include goodwill and similar intangible assets held by the seller that were not amortizable prior to the enactment of §197 and that were acquired from a related.
- For purposes of the anti-churning rules, a related party generally includes an entity with 20% common control with the selling member.
- In other words, if the selling practice was created prior to 1993, and the selling physicians retain 20% or more equity interest in the management company, the anti-churning rules would apply to limit the amortization of goodwill.

Deal and Tax Structuring Primary Intermediate Step - Alternative



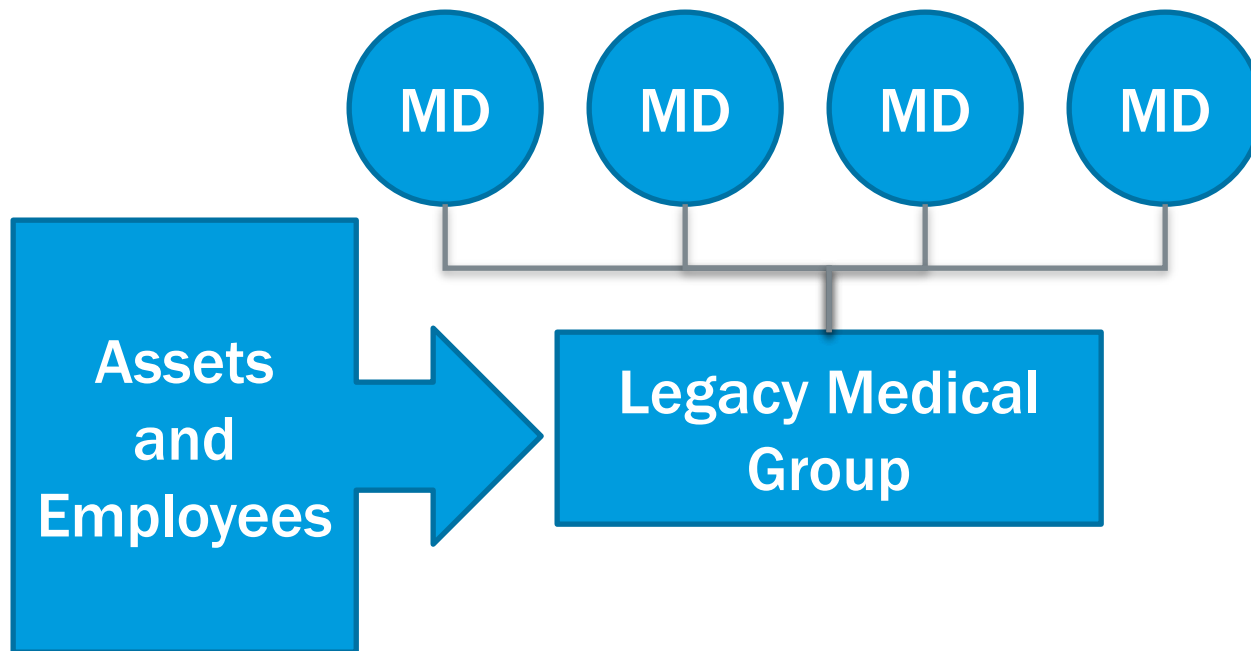
Deal and Tax Structuring

Tax Considerations

⌘ Anti-churning Rules

- Section 754 allows a partnership to make an election to adjust the basis of partnership property upon a transfer of a partnership interest, in the manner provided in §743.
- Section 743(b) provides, that in the case of a transfer of an interest in a partnership by sale or exchange, a partnership will increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property.
- Generally, so long as the purchaser is not related to the seller, the anti-churning rules do not apply to IRC 754/743 adjustments and amortization would be permitted.

Deal and Tax Structuring: Starting Structure – S-Corporation



Deal and Tax Structuring

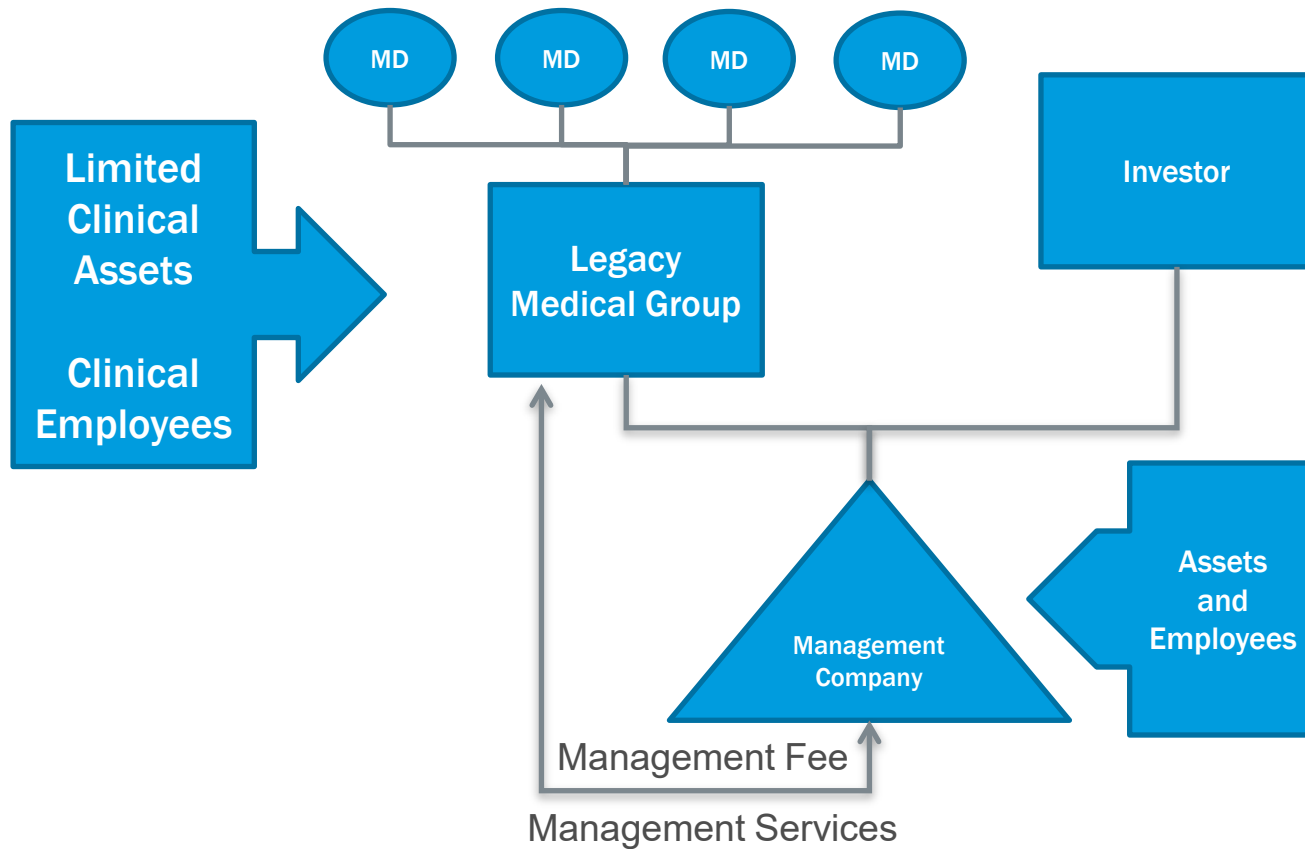
Tax Considerations

✚ S-Corporation Limitations

- 100 shareholders or fewer
- Shareholders cannot be partnerships, corporations, or non-resident aliens
- Only 1 class of stock permitted
- Must pay reasonable compensation
- Generally, no basis for debt
- Distribution of appreciated property triggers gain recognition.

Deal and Tax Structuring

Ending Structure – S-Corp



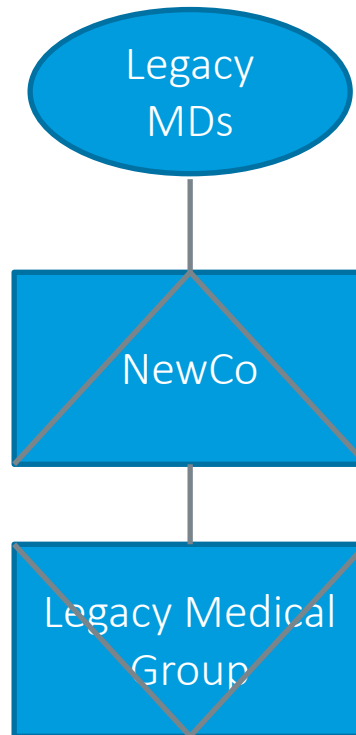
Deal and Tax Structuring

Tax Considerations

- ⚡ What happens when the medical practice wants to admit a new physician owner?
 - Promissory note & Installment sale complications
- ⚡ What if the pre-sale doctors want to distribute proceeds based on a measure other than stock ownership?

Tax Structuring – “F” Reorganization

- ✦ Shareholders of the legacy medical group form a new corporation (“NewCo”) by contributing the legacy medical group stock in exchange for the parent company stock and elect to treat as an S-corporation
- ✦ NewCo makes an immediate Qualified Subchapter S Subsidiary Election
- ✦ Section 368(a)(1)(F) provides that a reorganization includes a mere change in identity, form, or place of organization of one corporation

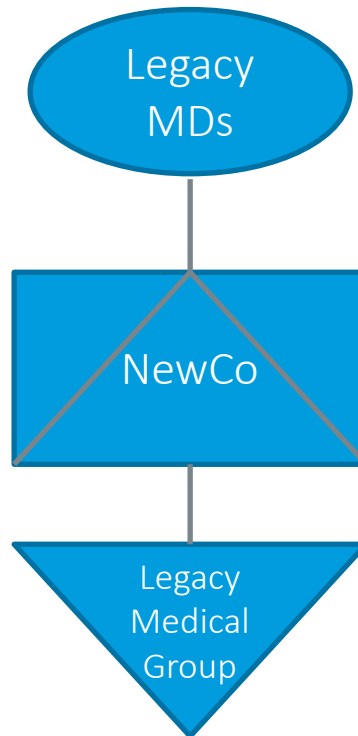


Tax Structuring – “F” Reorganization

✚ Legacy Medical Group converts to an LLC either through state law conversion statutes or through merger.

✚ Legacy Medical group can:

- Admit new profits-interests members
- Admit new capital-interests members pre-sale and change flow of deal proceeds

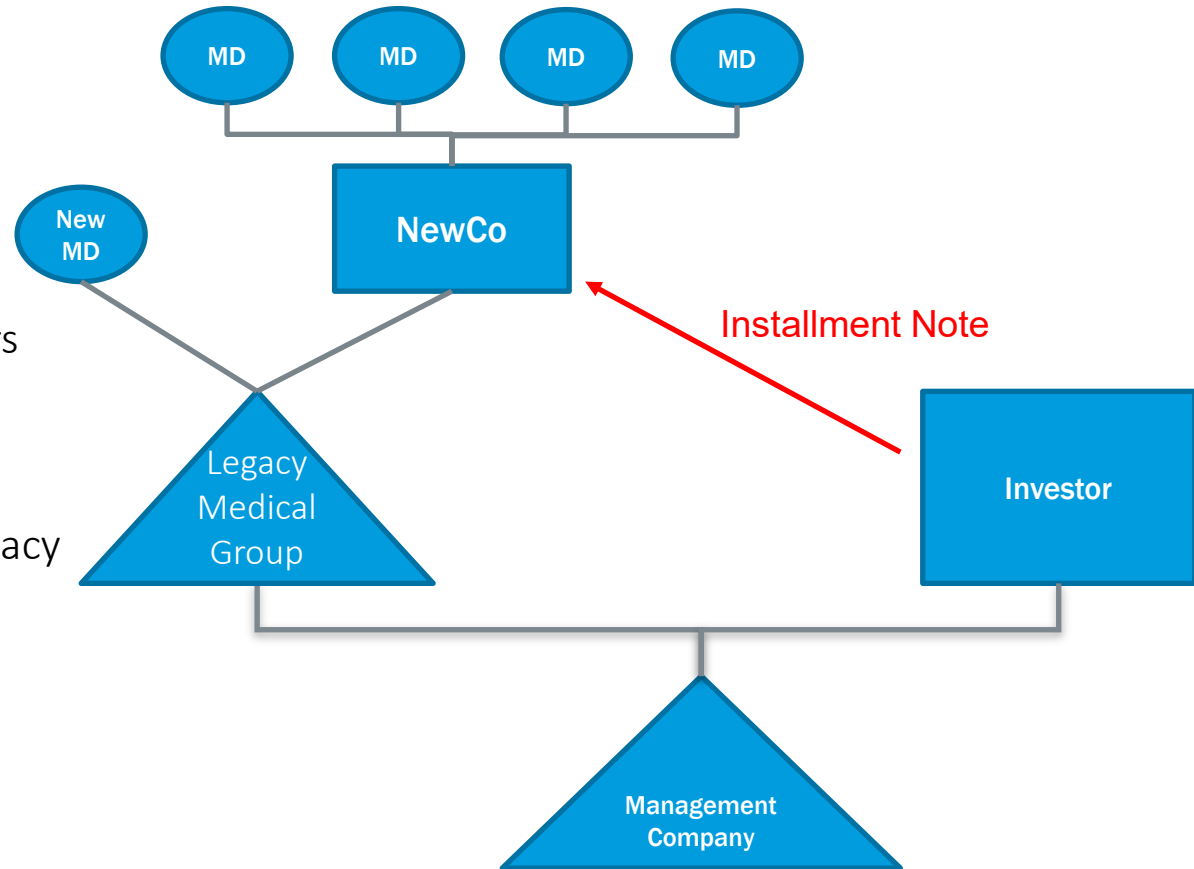


✚ NewCo can:

- Transfer ownership of the Management Company into a new SMLLC to admit new members

Deal and Tax Structuring

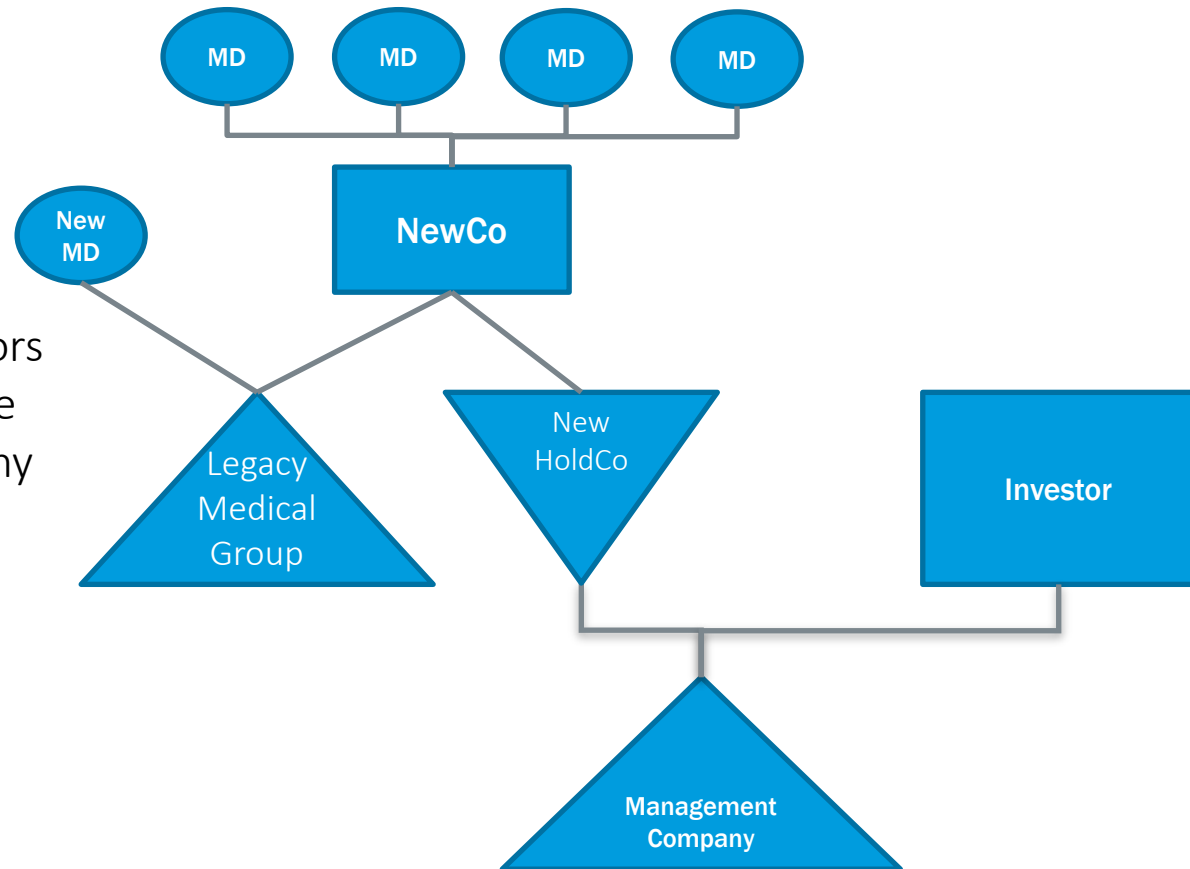
Alternative Structure – S-Corp



- ✚ Newly admitted doctors would not share in the installment sale
- ✚ Income can be disproportionate to legacy doctors.

Deal and Tax Structuring

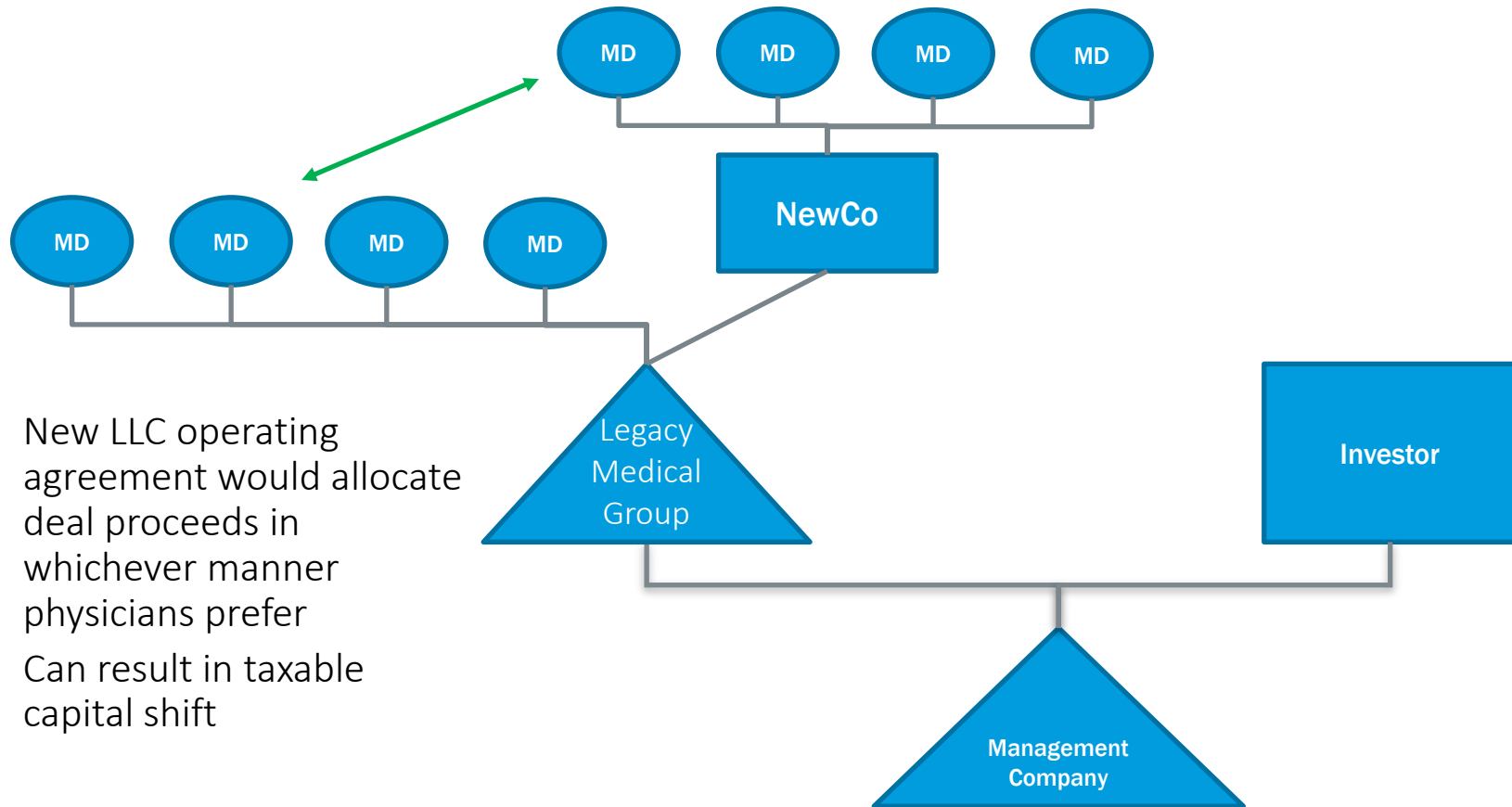
Alternative Structure – S-Corp



- ✚ Newly admitted doctors would not share in the Management Company income

Deal and Tax Structuring

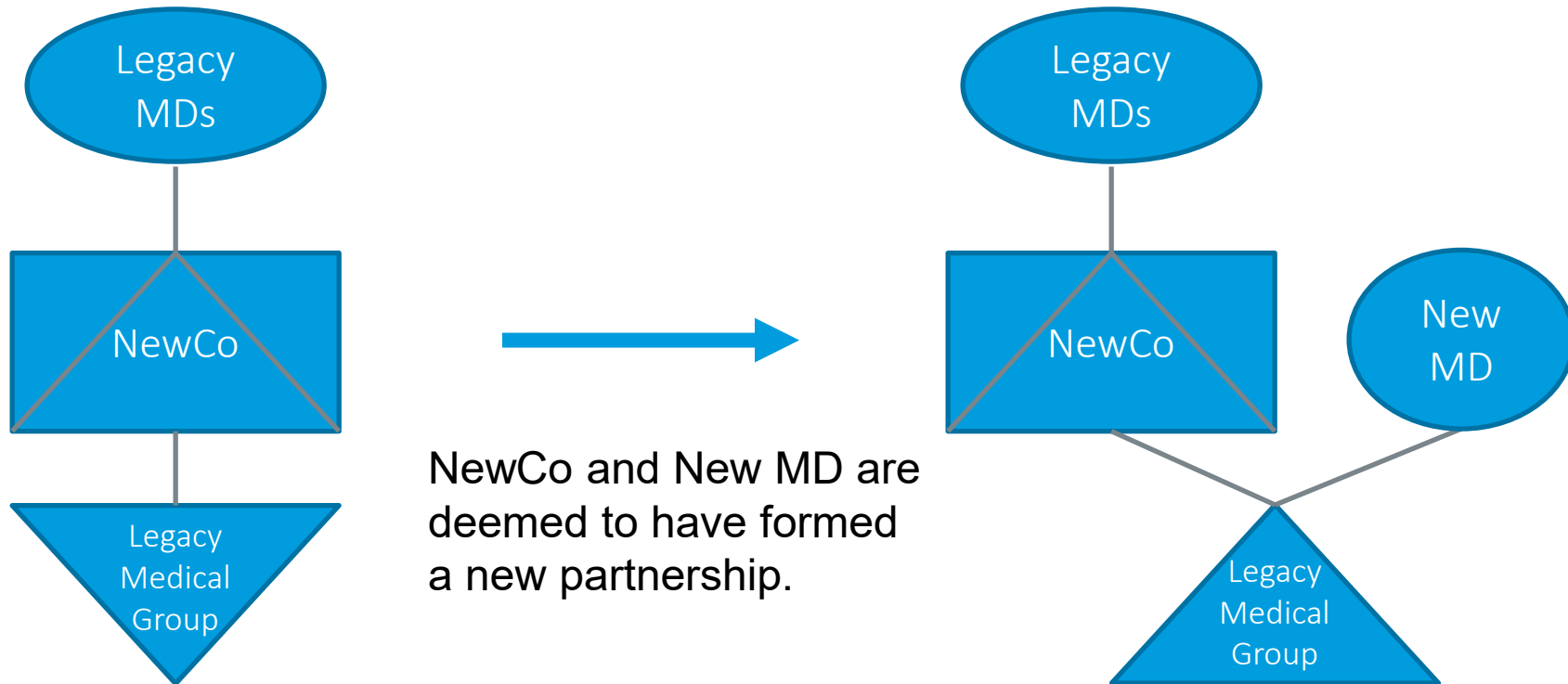
Alternative Structure – S-Corp



- ✚ New LLC operating agreement would allocate deal proceeds in whichever manner physicians prefer
- ✚ Can result in taxable capital shift

Tax Structuring – Rev. Rul. 99-5

- ✚ Converting from SMLLC to multi-member LLC governed by Rev. Rule 99-5
- ✚ Generally, non-taxable event under IRC §721



Other Tax Considerations

- ⌘ Interest expense limitation in IRC §163(j)

- ⌘ Character of gain on sale
 - Short-term vs. Long-term
 - Contribution of cash or receivables

- ⌘ Cash to accrual conversions

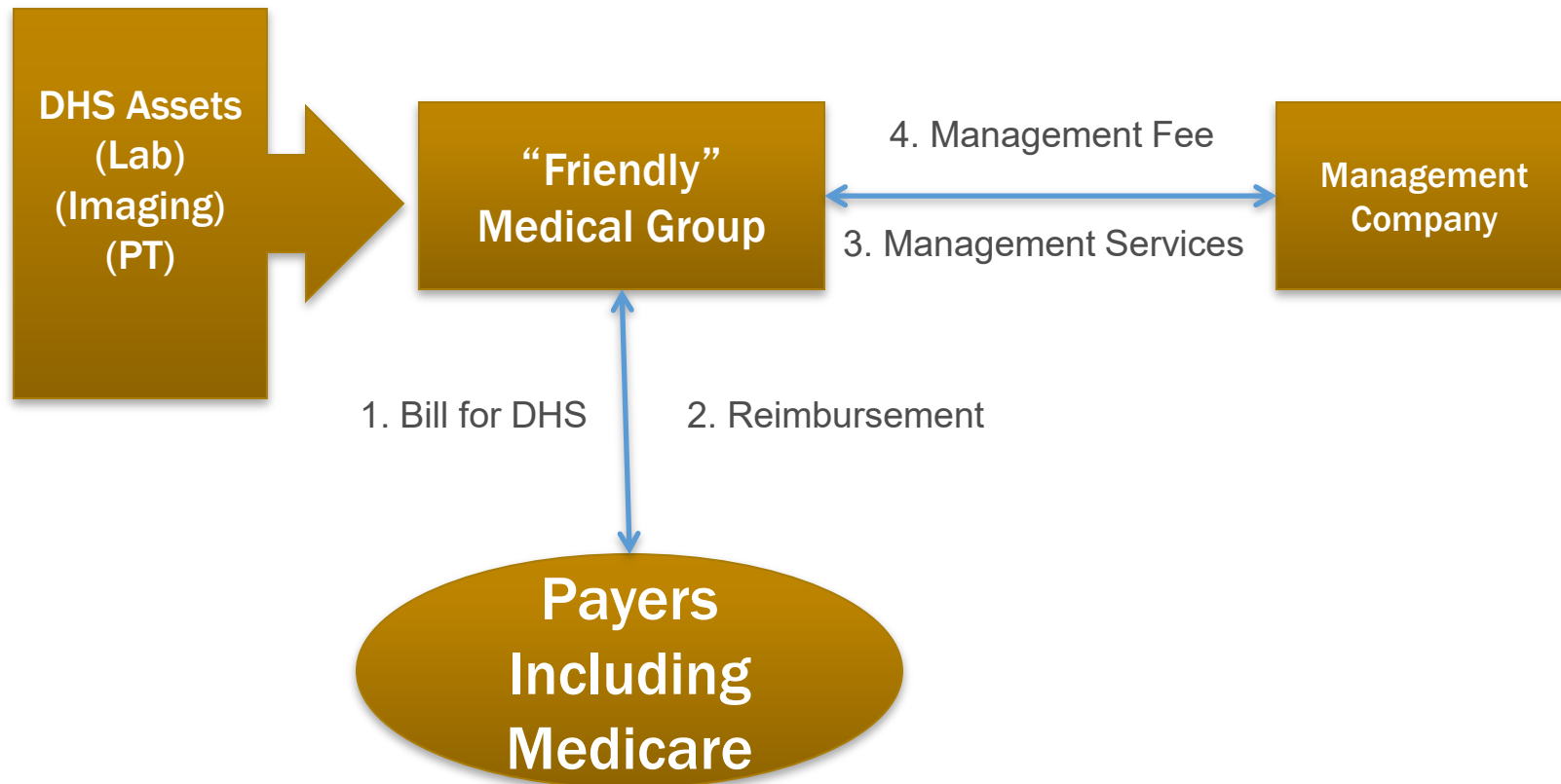
Other Tax Considerations

✦ Retaining EIN on Restructure

- Rev. Rul. 73-526 concludes that, in a transaction qualifying as a reorganization under § 368(a)(1)(F), the acquiring corporation should use the EIN of the transferor corporation
- However, since Rev. Rul. 73-526, the regulations under § 6109 have been amended to address the effect of QSub elections under § 1361
- §301.6109-1(i)(1) provides that any entity that has an EIN will retain that EIN if a QSub election is made for the entity under § 1.1361-3 or if a QSub election that was in effect for the entity terminates under § 1.1361-5
- §301.6109-1(i)(2) provides that, except as otherwise provided in regulations or other published guidance, a QSub must use the parent S corporation's EIN
- §301.6109-1(i)(3) provides that if an entity's QSub election terminates, it may not use the EIN of the parent S corporation after the termination
- If the entity had an EIN prior to becoming a QSub or obtained an EIN while it was a QSub in accordance with regulations or other published guidance, the entity must use that EIN.
- If the entity had no EIN, it must obtain an EIN upon termination of the QSub election
- Thus, the newly created S-Corporation parent must obtain a new EIN.
- Rev. Rule 2008-18.

Deal and Tax Structuring

Impact of DHS



Deal and Tax Structuring

- Impact of Designated Health Services
 - Implicates the Stark Law
 - Stark prohibits certain referrals by a physician for so-called “designated health services” (DHS) including lab and imaging reimbursed by Medicare unless the structure meets an exception
 - Requires a structure that preserves the so-called “in office ancillary services” exception
 - Failure to meet IOAS exception will make illegal physician referrals for DHS
 - Successfully meeting the IOAS exception obviates the need to meet other exceptions

Common Deal Terms and Indemnities

- Due diligence continues to be critical to most deals getting done—We are seeing a heavy emphasis on diligence matters
 - Often due to the fact that Friendly PC retains its provider number(s) and NPIs
 - In certain situations, agreements to self disclose prior to closing, or immediately after closing, are common
- Valuations appear robust—Not unusual to see 9-12x (sometimes greater) multiples on TTM EBITDA for platform companies in the private equity space

Deal Term Updates

- Escrows of 10%-15% of transaction value not uncommon
- Representations and Warranties insurance is being used on an increasingly regular basis
 - Coverage is generally around 10-15% of TEV
 - Self insured retentions (deductibles) are approximately 1-2% of of TEV; that SIR generally establishes the indemnity cap for Seller indemnity obligations for breaches of reps/warranties
 - Buyer pays the premiums in approximately 2/3 of the deals
 - Beware of carve outs for certain issues, such as “health care compliance” reps and warranties
 - Sellers should be prepared for a second round of diligence from counsel

Deal Term Updates

- Survival Periods (R&W)
 - General: 12-18 months
 - Fundamental: Unlimited
 - Taxes/Benefits: SOL + 60-90 days
 - Health Care: SOL = 60-90 days or 3-5 years (depending upon negotiations)
- Caps
 - Can be lowered through use of R&W insurance (as low as 1-5% of transaction value in some cases)
 - No cap, generally, on breaches of covenants or breaches of fundamental R&W
 - Higher caps, generally, on breaches of health care R&W

Restrictive Covenants

- 3 Key Documents
 - Purchase Agreement
 - Post-Closing Employment Agreement
 - Rollover Equity Governing Agreement
- State law on restrictive covenants must be reviewed
 - Permissibility of a restrictive covenant
 - Enforceability
 - Parameters

Restrictive Covenants

- Purchase Agreement
 - The restricted period will be tied to the closing date of the transaction, not the last day of a provider's employment post-closing nor to the date on which the provider sells all of the provider's rollover equity
 - The restricted period will typically be longer than the restricted period in the provider's post-closing employment agreement and the restricted period in the rollover equity governing agreement
 - The scope of the definition of a competing business is extremely important
 - The scope of the restricted territory is extremely important
 - Small ownership of a publicly traded company is typically carved out
 - A seller needs to carve out any other preexisting activities that may implicate the restrictive covenant

Restrictive Covenants

- Purchase Agreement
 - The non-solicitation clause will typically apply to employees, independent contractors, patients and referral sources
 - With respect to employees, is the clause merely a non-solicit or also a non-hire clause?
 - Is there an exception for general advertisements and/or any restrictions?
 - Is there a restricted lookback period on employees, independent contractors, patients and/or referral sources?

Restrictive Covenants

- Purchase Agreement
 - There may be a restriction prohibiting the provider's interference with the buyer's business relationships, particularly if the specialty is facility-based
 - There may be a non-disparagement clause
 - Negotiate to make this mutual
 - Carve out witness testimony

Restrictive Covenants

- Post-closing Employment Agreement
 - The restricted period will be tied to the last day of a provider's employment post-closing, not to the date on which the provider sells all of the provider's rollover equity or the closing date of the initial transaction
 - The restricted period will typically be shorter than the restricted period in the purchase agreement
 - The scope of the definition of a competing business is extremely important
 - The scope of the restricted territory is extremely important
 - Small ownership of a publicly traded company is typically carved out
 - A seller needs to carve out any other preexisting activities that may implicate the restrictive covenant

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Restrictive Covenants

- Rollover Equity Governing Agreement
 - There is more variation in the market on negotiation of this restrictive covenant
 - If the restricted period is tied to the date on which the provider sells all of the provider's rollover equity and the provider is unable to sell all of the rollover equity upon the provider's last day of employment, the provider may be bound by a restrictive covenant for a longer period
 - The scope of the restricted territory is extremely important, particularly if the rollover equity is in an entity that covers a wider geographic territory than that in which the provider provides professional services
 - Small ownership of a publicly traded company is typically carved out
 - A seller needs to carve out any other preexisting activities that may implicate the restrictive covenant

Restrictive Covenants

- Rollover Equity Governing Agreement
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Restrictive Covenants

- Rollover Equity Governing Agreement
 - Does the restrictive covenant only apply to providers or does it apply to non-providers as well?
 - Is the corporate opportunity doctrine disclaimed?
 - Are fiduciary duties disclaimed?
 - Is the private equity firm prohibited from engaging in any transactions through another entity?

Restrictive Covenants

- Post-Closing Employment Agreement
 - There may be a restriction prohibiting the provider's interference with the buyer's business relationships, particularly if the specialty is facility-based
 - There may be a non-disparagement clause
 - Negotiate to make this mutual
 - Carve out witness testimony

Restrictive Covenants

- All agreements
 - Blue pencil doctrine
 - Equitable relief
 - Liquidated damages
 - Legal fees
 - What happens if the buyer breaches an agreement?
 - What happens if the buyer terminates the provider post-closing without cause?
 - What happens if the provider terminates the provider's post-closing employment agreement for good reason?
 - What happens if the buyer attempts to enforce the restrictive covenant and does not prevail?

Rollover Equity

- In many transactions, the buyer will require that some of the consideration paid to the seller be rolled over into equity in a buyer entity
- The particular portion to be rolled over varies from deal to deal
- The buyer entity may be a newly formed subsidiary, an intermediary or a parent entity
 - The entity may be used only to provide management services to the particular provider's practice or to multiple practices in a defined geographic territory or particular specialty or on a national basis
- The rollover equity may or may not include voting rights

Rollover Equity

- The economic benefits of the rollover equity may be limited to a “second bite of the apple” or may include ongoing distributions limited to revenue from a particular practice or multiple practices or particular specialties or on a national basis
- In structuring distributions, careful attention must be paid to the Stark Law, the Anti-Kickback Statute and applicable state versions of these laws

Rollover Equity

- Governance
 - Will the provider have any voting rights?
 - If there are any, are they limited to certain issues?
 - Will the provider have a seat on the Board or have the right to vote for any Board spots?
 - What decisions can the Board make versus the owners?
 - What is the composition of the Board?
 - Does the Board include any providers?

Rollover Equity

- Put/call options
 - Does the entity or any owners of the entity have the right to redeem/purchase the provider's rollover equity (all or part)?
 - What are the triggering events?
 - What is the formula for the purchase price?
 - Does the provider have the right to require the entity or certain owners of the entity to redeem/purchase the provider's rollover equity (all or part)?
 - What are the triggering events?
 - What is the formula for the purchase price?

Rollover Equity

- Tag-along rights
 - If the private equity firm sells all or part of its equity in the rollover entity to a third party, does the provider have the right to “tag along” with all or part of the provider’s rollover equity?
 - Consideration
 - Time periods
 - Percentages

Rollover Equity

- Drag-along rights
 - If the private equity firm sells all or part of its equity in the rollover entity to a third party, does it have the right to “drag along” all or part of the provider’s rollover equity?
 - Consideration
 - Percentages

Challenges Resulting From Covid-19

- **Medicare Advanced Payments** - treated as debt for purposes of the transaction
- **Payroll Protection Program Loans**
 - “Change of ownership” defined in SBA Procedural Notice as:
 - The sale or transfer of at least 20% of the equity of a PPP borrower, whether in one or more transactions, including to an affiliate or existing owner of the PPP borrower;
 - The sale or transfer of at least 50% of the PPP borrower’s assets (measured by fair market value) in one or more transactions; or
 - The merger of a PPP borrower with or into another entity.
 - If a borrower’s PPP loan is fully satisfied upon the occurrence of a change in ownership, there are no restrictions on such change in ownership.
 - A PPP loan is considered “fully satisfied” if the PPP borrower has (a) repaid the note in full, or (b) completed the loan forgiveness process in accordance with PPP requirements and either SBA has remitted funds to the PPP lender in full satisfaction of the loan or the PPP borrower has paid any remaining balance on the loan.
 - if the loan is not fully satisfied at the time of a change in ownership, the PPP borrower must follow the procedures set forth in the Procedural Notice, which differ based on the type of ownership change

Challenges Resulting From Covid-19

- The PPP lender may approve the sale or transfer of 50% or less of the equity of a PPP borrower or 50% or more of the PPP borrower's assets, in each case without SBA's prior consent, if the following conditions are met:
 - The PPP borrower must complete and submit a loan forgiveness application, together with required supporting documentation, to the PPP lender;
 - An interest bearing escrow account controlled by the PPP lender must be established with funds equal to the outstanding balance of the PPP loan; and
 - Once the loan forgiveness process is complete, the escrow funds must first be disbursed to pay any remaining PPP loan balance plus interest.
- In all other cases, the PPP lender cannot unilaterally approve the change of ownership but must instead submit a request for approval, together with required documentation, to the appropriate SBA loan servicing center.

Challenges Resulting From Covid-19

- **CARES Act Provider Relief Funds** – terms and conditions are evolving and uncertain
 - Funds received between April 10, 2020-June 30, 2020: use by June 30, 2021 and report from July 1, 2021-September 30, 2021
 - Funds received between July 1, 2020-December 31, 2020: use by December 31, 2021 and report from January 1, 2022-March 31, 2022
 - Funds received between January 1, 2021-June 30, 2021: use by June 30, 2022 and report from July 1, 2022-September 30, 2022
 - Funds received between July 1, 2021-December 31, 2021: use by December 31, 2022 and report from January 1, 2023-March 31, 2023

Challenges Resulting From Covid-19

- If the transaction is a purchase of the recipient entity (e.g., a purchase of its stock or membership interests), then the Provider Relief Fund recipient may continue to use the funds, regardless of its new owner
- If the transaction is an asset purchase (whether for some or all of the Provider Relief Fund recipient's assets), then the original recipient must use the funds for its eligible expenses and lost revenues and return any unused funds to HHS as the Provider Relief Fund money does not transfer to the buyer

Regulatory and Compliance Issues

- Impact of AKS and Stark Law
 - FMV payments still a concern
 - Stark Law DHS issues
- State Law CPOM and Licensure
- Compliance Issues in Diligence
 - Billing and coding (“up” coding and incorrect use of modifiers)
 - Improper billing for physician extender
 - Billing when charting is incomplete

Hot Diligence Issues

- Anti-Referral Issues

- Violations of Physician Anti-Referral laws (Stark) remain a significant concern
- OIG Fraud Alert (June 2015)
 - Emphasized the need for FMV payments to MDs for bona fide services
 - Problematic arrangements include (i) those above FMV, (ii) compensation that takes into account v/v of referrals, (iii) MDs failing to provide contracted services and (iv) affiliated health care entity paying for physician office staff
 - Shot across the bow to physicians who sometimes believe they won't be targeted for abusive situations

Regulatory and Compliance Issues

- Anti-Referral Issues

- Physician compensation, particularly stacking of compensation that leads to high aggregate compensation amounts
- Focus on FMV, including the selection of benchmarks and the quality of reports
- Focus on the accuracy, reliability and completeness of information provided to advisors
- Questioning of commercial reasonableness of compensation arrangements when reasons for the arrangement are not well documented

Regulatory and Compliance Issues

- Anti-Referral Issues
 - North Broward Settlement
 - \$69MM settlement for FCA and Stark law violations (including a 5 year CIA)
 - Adventist Settlement
 - \$115MM to settle Stark law and Medicare coding claims

Regulatory and Compliance Issues

- **Anti-Referral Issues**
 - Employment Safe Harbor (AKS) is not bullet proof and doesn't give you cover under the Stark Law
 - If you have high compensation relative to MGMA percentiles, have good documentation to support the compensation
 - Watch use of internal reports, related to physician use/referral to ancillaries—regulators will use it to “connect the dots”