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Basic Transaction Structures in Health Care M&A

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The structure of M&A transactions in the health care industry may be affected by various commercial, legal, regulatory, tax, and other considerations. Many health care transactions are structured as outright acquisitions by one company of the entire business (or an entire division or business unit) of another company. Such acquisitions are typically structured as stock purchases, mergers, tender offers, or asset purchases. Alternatively, a buyer might choose to purchase a specific product or portfolio of products owned by the target company. Such acquisitions are common in the pharmaceutical and biotechnology industries and are typically structured as asset purchases.

In addition to these traditional M&A forms, a variety of alternative transaction structures are used in health care M&A.

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These alternatives are often designed to address the various risks that may arise in M&A transactions generally, such as those relating to a buyer's potential failure to accomplish its commercial objectives, as well as to mitigate special legal and other risks associated with transactions in a heavily regulated industry such as health care. These risk-mitigating structures, which may or may not involve an outright acquisition by one company of another company's business or products, include license-and-collaboration agreements (see chapter 4), joint ventures and strategic alliances (see chapter 5), option agreements, investment agreements, and certain other structures.

This chapter focuses on the traditional M&A transaction structures involving whole business acquisitions. In addition, it covers product and portfolio acquisitions and transactions structured as option deals. It also reviews considerations that are relevant to deciding between a stock purchase and an asset purchase. Other forms of health care transactions are discussed in more detail elsewhere in this book.[1]

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Acquisition of the Whole Business

Q 1.1 What is a whole business acquisition?

M&A transactions often result in a whole business acquisition, in which the buyer acquires the entire business of a target company (or an entire division or business unit) or all or substantially all of its assets. Examples of such transactions include mergers of hospital systems or acquisitions of physician practices by hospitals. Whole

business acquisitions also include transactions in which a large pharmaceutical company acquires a biotechnology firm in order to bolster its product pipeline.

The most common structures used in whole business acquisitions are stock purchases, mergers, tender offers, and asset purchases. These transaction forms are briefly discussed below.

Q 1.1.1 What is a stock purchase?

In a stock purchase, the buyer purchases the shares of the target's stock from its stockholders. As a result of the transaction, the target becomes a subsidiary of the buyer.

In such a transaction, all of the assets and liabilities of the target—including its unknown or undisclosed liabilities—remain with the target following the transaction. The parties typically are not required to take any action to transfer the target's business or assets to the buyer. Moreover, a stock deal generally will not trigger anti-assignment provisions in the target's contracts, although the parties will need to identify any regulatory approvals and third-party consents that may be required in connection with the change of control of the target that occurs as a result of the transaction.

The stock purchase structure is a practical means of acquiring all of the outstanding equity in a target company only if the target has a relatively small number of stockholders. If the target is a publicly traded company or a privately held company with a large number of stockholders, having all of the target's stockholders sign a purchase agreement will typically be impossible or impractical. As a result, the acquisition of all of the target's stock will need to be structured as a merger or a tender offer.

And a stock purchase will not be possible, of course, if the target has no stock. Approximately 73% of all U.S. community hospitals (other than those owned by state or local governments) continue to be operated by nonprofit corporations,[2] and, with few exceptions, nonprofit corporations do not issue stock. Instead, they may have "members" (ordinarily one or more other nonprofit organizations) or, more commonly, do not have members and are governed by a self-perpetuating board of directors. Accordingly, such an entity may be acquired either by transfer of the existing membership interests

or, more typically, by transfer of the authority to appoint, remove, and replace the members of the target's board of directors. Such a transaction generally presents the same successor liability and regulatory compliance issues as a stock purchase.[3]

Q 1.1.2 What is a merger?

In a merger, the buyer enters into a merger agreement with the target, pursuant to which the surviving company succeeds to all of the target's rights and obligations, and the target's equity is converted into the right to receive merger consideration, which can consist of cash, stock, other securities or property, or a combination of these.

Many merger transactions are structured as "triangular mergers," in which the buyer forms a wholly owned subsidiary that is merged with the target company. Triangular mergers may be "forward" or "reverse." In a forward triangular merger, the target is merged into the buyer's acquisition subsidiary, with the acquisition subsidiary surviving. In a reverse triangular merger, the buyer's acquisition subsidiary is merged into the target, with the target surviving as a wholly owned subsidiary of the buyer. The choice of which company (the buyer's acquisition subsidiary or the target) should be the surviving company is usually dictated by tax considerations, brand recognition, and other legal and commercial factors that the parties deem important.

In a merger, all of the assets and liabilities of the merging entities are combined in the surviving company. Thus, a merger is similar to a stock purchase in that all of the assets and liabilities of the target, including unknown and undisclosed liabilities, are transferred to the surviving entity automatically by operation of law. Also like a stock purchase, a reverse triangular merger generally will not constitute an "assignment" under the target's contracts and will not trigger anti-assignment provisions that restrict an "assignment by operation of law," although it may constitute a "change of control" of the target that will require the parties to obtain certain regulatory approvals and third-party consents.[4] In contrast, a forward triangular merger does result in an assignment by operation of law because the target is not the surviving entity and its rights and liabilities vest in the surviving entity.

Unlike a stock purchase, in which each stockholder of the target must agree to sell its shares to the buyer, but the approval of the target's board of directors is not required, a merger usually requires the approval of the target's board as well as the vote of the holders of a specified percentage of the target's shares (in most states, a majority of the target's outstanding voting shares). However, in a merger, dissenting stockholders may have appraisal rights to receive the fair value of their shares, as determined by a court.

What if the target is a nonprofit corporation? If the buyer is also a nonprofit corporation, a merger may be used. If the buyer is a for-profit organization, then for a merger to be used, the nonprofit seller would first have to reorganize so as to isolate the subject assets and liabilities in a for-profit organization—for example, where permitted by applicable state law, by way of a transaction in which the subject assets and liabilities are dropped down into a for-profit entity.

Q 1.1.3 What is a tender offer?

If the target is a publicly traded company, a buyer may launch a tender offer for the target's shares. A tender offer is an offer to purchase the target's shares directly from its public stockholders. A successful tender offer is almost always followed by a "squeeze-out" merger, typically at the same price, to buy out any minority stockholders who do not tender their shares into the tender offer. Such transactions are often referred to as "two-step" transactions, as opposed to "one-step" mergers not preceded by a tender offer.

In a "friendly" transaction—that is, a transaction supported by the target's board of directors—the tender offer and the back-end merger are effected pursuant to a merger agreement between the buyer and the target. But the tender offer structure allows the buyer to go directly to the target's stockholders even if the target's board opposes the transaction.

In a two-step transaction, if 90% or more of the target's outstanding shares are tendered into the tender offer, the buyer typically can effect a "short-form" merger under applicable state law to squeeze out the remaining minority stockholders. In a short-form merger, the merger is effected without a vote of the target's stockholders. Upon filing of the short-form merger certificate with the secretary of state, the

stockholders who did not tender their shares into the tender offer will no longer have any rights to their shares, other than the right to receive the same consideration paid to the other stockholders in connection with the tender offer.

The primary advantage of the two-step structure is that it may allow the buyer to take control of the target more quickly than in a one-step merger, thereby limiting the risk of competing bids. Under the two-step structure, it may be possible for the buyer to acquire a majority of the target's stock within approximately four to six weeks after launching its cash tender offer. In contrast, a one-step merger typically cannot be completed in less than three months after the parties sign a definitive merger agreement. As a result, in a one-step merger, the buyer will not acquire control of the target until the merger is completed, which increases the transaction's vulnerability to competing bids due to the length of the period between the announcement of the transaction and the shareholder vote on the merger.

EXAMPLE: Salix Pharmaceuticals, a pharmaceutical company producing and marketing drugs for treatment of gastrointestinal disorders, entered into a merger agreement to acquire Santarus, Inc. on November 7, 2013. Pursuant to the merger agreement, Salix launched the first-step tender offer on December 3, 2013, and completed the second-step merger on January 2, 2014. Similarly, Roche entered into a merger agreement to acquire InterMune, Inc. on August 22, 2014. Roche launched a tender offer for all of InterMune's outstanding common stock on August 29, 2014, and completed the back-end merger on September 29, 2014.

Moreover, a 2013 amendment to the Delaware corporation statute allows a bidder for a public Delaware corporation to effect a second-step merger without obtaining a shareholder vote, even if the bidder owns less than 90% of the target's outstanding voting stock, if upon completion of a tender offer made pursuant to a merger agreement with the target, the bidder owns at least the number of target shares

required to approve the merger—that is, a majority of the outstanding shares, unless the target has increased the threshold in its charter—and certain other conditions are met.[5]

EXAMPLE: Merck & Co., Inc. entered into a merger agreement to acquire Cubist Pharmaceuticals, Inc., an antibiotics manufacturer, on December 8, 2014. Pursuant to the merger agreement, Merck launched a tender offer for all of Cubist's outstanding common stock on December 19, 2014. The merger agreement provided that the transaction would be governed by section 251(h) of the Delaware General Corporation Law, which allowed the parties to complete the back-end merger on January 21, 2015, after about 75% of Cubist's common shares had been tendered.

However, if the acquisition is subject to inherent and prolonged regulatory delays (for example, due to antitrust concerns), the two-step structure may not result in any timing advantage and the transaction typically will be structured as a one-step merger.

EXAMPLE: In July 2015, Aetna Inc. announced its agreement to acquire Humana Inc., a health insurance company, for $37 billion. In anticipation of a tough antitrust review, the transaction was structured as a one-step merger. At the time of writing, the transaction is still being reviewed by the U.S. Department of Justice.

EXAMPLE: In February 2014, Actavis PLC agreed to acquire Forest Laboratories, Inc. for $25 billion. Because heavy antitrust scrutiny of the proposed acquisition was expected, the transaction was structured as a one-step merger. Indeed, almost immediately after the merger agreement was announced, the FTC issued a complaint against the acquisition, citing antitrust concerns relating to the anticipated impact of the merger on the markets for four drugs. In order to settle the complaint, the parties ultimately agreed to relinquish their rights to market the drugs. The acquisition closed on July 1, 2014, approximately four-and-a-half months after the merger agreement was signed. In these circumstances, using the tender offer structure would likely have not resulted in any timing advantage.

EXAMPLE: Teva Pharmaceutical Industries Ltd. announced its agreement to acquire the drug maker Cephalon, Inc. on May 2, 2011. Heavy scrutiny of the proposed transaction by U.S. and European antitrust authorities was expected. As a result, the acquisition was structured as a one-step merger. Indeed, antitrust approvals of the transaction were not granted until October 2011, subject to certain conditions imposed by the antitrust agencies, and the transaction was not completed until October 14, 2011, more than five months after the announcement. As in the previous example, there would have been no benefit in using the tender offer structure in this transaction.

In such situations, a one-step merger may be the better approach because, once shareholder approval is received, the transaction will not be vulnerable to a potential topping bid while the parties pursue the necessary regulatory approvals. In the two-step structure, the transaction remains exposed to topping-bid risk until all regulatory approvals are obtained and the tender offer closes.

Q 1.1.4 What is an asset purchase?

In an asset purchase, the buyer purchases some or all of the assets of the target company or one of its divisions or business units. The main advantage of the asset purchase structure is that, as a general rule, the assets and liabilities of the target do not transfer to the buyer by operation of law. Rather, the buyer acquires only those assets and assumes only those liabilities that are specified in the purchase agreement.

Since the asset purchase structure gives the buyer the flexibility, subject to certain exceptions, to choose which of the target's assets and liabilities it would like to acquire, this transaction form is also widely used in acquisitions where the buyer wishes to leave behind some of the target's assets or liabilities, typically in transactions involving privately held targets. In addition, this structure is often used in acquisitions of business units or divisions that are not operated as separate corporate entities, as well as in product and portfolio acquisitions.

If the target is a state-licensed health care facility (for example, a hospital, long-term care facility, or ambulatory surgery center), the traditional advantages associated with the buyer's ability to pick and choose amongst the assets to be purchased while delimiting the obligations that will be assumed must be measured against various regulatory restrictions on the transfer of the target's licenses and on the buyer's ability to avoid successor liability to federal and state health care programs (for example, Medicare and Medicaid) for the target's pre-closing actions,[6] as well as any anti-assignment clauses in the target's contracts.

Product and Portfolio Acquisitions

Q 1.2 What is a product or portfolio acquisition?

In a product or portfolio acquisition, the buyer purchases from the seller one or more products, typically in different phases of development, and thus obtains the right to manufacture and market these products. Product and portfolio acquisitions are prevalent in the pharmaceutical and biotechnology industry as an important means by which drug and medical device manufacturers can expand their product portfolios and research and development (R&D) pipelines.

Product or portfolio acquisitions are typically structured as asset purchase transactions and involve the assignment of the relevant patent rights. For example, in a transaction involving the acquisition of a pharmaceutical compound or medical device, the buyer typically acquires the seller's rights to one or more specified products, together with the related intellectual property rights, including patents and trademarks, product registrations necessary for the commercialization of the acquired products, clinical and other data related to the products, and certain other related assets and liabilities.

Option Transactions

Q 1.3 What are typical M&A structures in the pharmaceutical and biotechnology industries?

One of the primary driving forces in M&A deals in the pharmaceutical and biotechnology sector is the need for large pharmaceutical companies to supplement their R&D efforts with acquisitions of smaller pharmaceutical or biotechnology companies with promising early-stage product candidates. While such acquisitions constitute an important source of product pipeline expansion for major drug manufacturers, they also involve significant risks associated with the uncertainty of early-stage drug development.

As a result, these transactions are often structured to mitigate the risk of the target's products (or frequently its sole product) never reaching the marketplace. The structures that are often utilized in such transactions include, among others, licensing agreements,[7] contingent value rights (CVRs),[8] and option agreements. Option agreements are discussed here.

Q 1.4 What are the key terms of an option transaction?

In an option transaction, rather than acquiring a target company outright, the buyer makes an initial up-front payment to the target, and the target grants the buyer an option to acquire the target at an agreed price. The purpose of this arrangement is to provide the target with financing necessary to continue its product development activities, while allowing the buyer not to commit to acquiring the target unless and until it becomes clear that the target's products are likely to succeed in clinical trials and be approved by the FDA.

The parties to an option transaction typically enter into an agreement specifying the option terms (such as the exercise price, duration, manner of exercise, etc.) as well as other terms and conditions of the transaction. Such other terms include provisions relating to the target's (R&D) plan and the extent to which the buyer may become involved in the target's drug development process; the target's obligations to provide information to the buyer (including information relating to the applicable product development milestones); and interim conduct of the business covenants (including, among others, restrictions on the target's ability to enter into licensing agreements with respect to its products and covenants relating to employee compensation arrangements).

Q 1.4.1 What is the purpose of the up-front payment?

The purpose of the up-front payment in an option transaction is to fund the continuing (R&D) of the target's product candidates. Thus, the amount of the up-front payment has to be sufficient to enable the target to develop its products until they reach the point where the buyer can decide whether to exercise the option. Moreover, the target may want the up-front payment to include a cushion that will allow the target to fund its operations if the buyer elects not to exercise the option, until the target finds another buyer or an alternative source of funding.

EXAMPLE: In June 2015, Celgene Corporation entered into an agreement with Juno Therapeutics, Inc., pursuant to which Celgene acquired a 10% initial stake in Juno and made an up-front payment of approximately $150 million to Juno to develop and commercialize novel immunotherapies for the treatment of cancer and autoimmune diseases. In exchange, Celgene received the right to purchase additional equity in Juno during a ten-year term, such that Celgene could ultimately own up to 30% of Juno's common stock.

EXAMPLE: In October 2014, Bristol-Myers Squibb Company entered into an agreement with F-star Alpha Ltd., pursuant to which Bristol-Myers Squibb made a $50 million up-front payment and agreed to fund the development of a treatment for breast and gastric cancer that F-star was developing. In exchange, Bristol-Myers received an exclusive option to acquire F-star upon its decision to commence a second-phase trial of the treatment.

On the other hand, the buyer wants to pay as little as possible for the option, especially because the option exercise price that the buyer agrees to pay to ultimately acquire the company, when combined with the up-front payment, is often higher than the price that the buyer would pay for the company in an outright acquisition. One way of bridging this gap is to supplement the up-front payment with additional payments that the buyer is required to make in order to retain the option if certain product development milestones are reached prior to the expiration date of the option.

The option structure is sometimes combined with a CVR or earnout arrangement: in addition to the up-front payment, the buyer agrees to make milestone payments to the target's former owners after the acquisition is completed in the event that certain specified benchmarks are met, such as sales targets. This is another structural alternative that may allow the buyer to minimize the up-front payment and thus mitigate the cost of a failed trial.

> **EXAMPLE:** In the second quarter of 2012, Pfizer entered into an option and merger agreement with NextWave Pharmaceuticals, a manufacturer of an ADHD drug, pursuant to which Pfizer made an up-front option payment of $20 million. The option was exercised in October 2012 with a $255 million payment made to NextWave shareholders at the closing. Under the terms of the option and merger agreement, Pfizer also committed to make additional payments of up to $425 million to the former shareholders of NextWave if certain post-closing sales milestones were met.

Q 1.4.2 What determines the duration of the option?

Obviously, the buyer would like to retain the option for as long as possible, to better judge the likelihood of the target successfully completing its drug development process. On the other hand, the longer the option period, the more funding the target will need for its (R&D) activities. From the target's perspective, while the option should allow the target sufficient time to complete its drug development process, it also wants to be able to pursue other alternatives if the option is not exercised by a specific point in time.

The option may have either a fixed expiration date or a term linked to a specific product development milestone. For example, the option agreement may provide that the option will expire if not exercised by the buyer within a certain period after the target completes its clinical trials and provides the results to the buyer.

EXAMPLE: In December 2012, Celgene Corporation began collaborating with Sutro Biopharma, Inc., a biopharmaceutical company, on the development of new antibody drugs. In September 2014, Celgene entered into another agreement with Sutro, pursuant to which Celgene agreed to pay Sutro $95 million in exchange for an increased equity stake in Sutro and an option to acquire the remaining equity of Sutro. The option expires upon the termination of the research term, but may be extended by Celgene by paying an additional fee.

EXAMPLE: In November 2011, Celgene Corporation entered into an agreement with Quanticel Pharmaceuticals, pursuant to which it committed to pay $45 million to Quanticel over a three-and-a-half-year period to facilitate cancer drug research. In return, Celgene received a forty-month technology license, an equity stake in Quanticel, and an exclusive option to acquire the balance of Quanticel's equity at the end of the investment term.

EXAMPLE: In January 2013, Cephalon, Inc. purchased an option to acquire Ception Therapeutics, Inc., a biopharmaceutical company. In exchange for an up-front payment of $100 million, the option allowed Cephalon to purchase all of Ception's outstanding stock for $250 million, and was exercisable during a specified term after receipt of the final study report from the clinical trial of one of Ception's lead drugs.

> **EXAMPLE:** In September 2012, the Medicines Company made an equity investment in Annovation Biopharma, Inc., a biotechnology start-up company, and acquired an option to purchase Annovation. The option was exercisable within thirty days following the completion by Annovation of a clinical proof-of-concept (POC) study with respect to Annovation's lead, next-generation, novel anesthetic. The Medicines Company exercised the option and acquired Annovation in February 2015.

While the fixed-date approach arguably allows for more certainty and predictability, it may enable the target to manipulate the deal process by delaying its clinical trials or otherwise preventing the buyer from obtaining information necessary to determine whether to exercise the option. One possible way to address this issue is to provide that the expiration date will be automatically extended for an agreed-upon period if the target fails to complete its clinical trials by a specific date.

In contrast, if the option has a term linked to a specific product development milestone, this approach assures the buyer that it will have the necessary information by the time it needs to decide whether to exercise the option. However, this approach has the potential for leaving the option outstanding indefinitely if the target is unable to complete the clinical trials. A possible compromise may be to agree that the option will be triggered by either the occurrence of an outside date or the completion of the clinical trials.

Q 1.4.3 How is the option transaction documented?

The option structure can be documented through (1) an option agreement to which a form of acquisition agreement is attached as an exhibit, to be executed by the parties if the option is ultimately exercised, or (2) an acquisition agreement incorporating the option terms. In either case, whether the acquisition will be structured as a merger, stock purchase, or asset purchase will typically depend on certain transaction specific factors, as discussed in more detail below.

Other Structuring Considerations

Q 1.5 What other factors may affect the structuring decision in health care M&A transactions?

The structure of any M&A transaction in the health care industry is often driven primarily by the parties' commercial objectives. For example, if a hospital wishes to acquire an ambulatory surgery center organized as a separate legal entity, the transaction may be structured as either a stock (or other equity) purchase or an asset purchase, depending on certain regulatory and other considerations. In contrast, if the target company owns several hospitals that are not held in separate subsidiaries and the buyer is interested in purchasing one, a merger or stock purchase may not be feasible. In that case, the transaction may need to be structured as an asset purchase or, alternatively, as a two-step acquisition, wherein the seller (1) "drops down" the target business to a controlled subsidiary, and then (2) transfers control of that subsidiary to the buyer.

Similarly, as discussed above, if a large pharmaceutical company is looking to augment its product pipeline by acquiring a smaller biotechnology company whose product candidates are in the early stages of product development, the buyer may want to structure the transaction as an option deal rather than an outright acquisition in order to mitigate the risk that the target's products never reach the marketplace.

However, when their commercial objectives can be accomplished through alternative transaction structures, the parties will usually take into account other relevant considerations. As discussed in more detail elsewhere in this book, in the United States and most other countries, the health care industry operates within an intricate regulatory scheme. As a result, M&A transactions involving health care providers (such as hospitals, physician practices, and other care providers) or producers of health care products and technologies (such as pharmaceutical and biotechnology companies) raise a variety of complex regulatory, governance, financing, and other issues that require careful structuring and documentation. Parties to health care transactions should take into account these factors in order to achieve their business objectives while minimizing their exposure to potential liabilities and simplifying the closing process.

Q 1.6 When should the transaction be structured as a stock purchase as opposed to an asset purchase?

As noted above, in deciding whether their transaction should be structured as a stock purchase or asset purchase, the parties will be guided primarily by their business goals. However, if either transaction form is feasible, in structuring the transaction, the parties will generally take into account, among other things, the following additional considerations:

- The parties' ability to exclude certain assets and liabilities of the acquired business from the transaction (Q 1.6.1);
- Tax consequences of the transaction to the parties (Q 1.6.2);
- Regulatory notices and approvals and third-party consents required in connection with the transaction (Q 1.6.3); and
- Documentary considerations and the mechanics of transferring the acquired business (Q 1.6.4).

Q 1.6.1 What are assumed vs. excluded assets and liabilities?

In a merger, all of the assets and liabilities of the target company, including unknown and contingent liabilities, are transferred to the surviving company by operation of law. Similarly, in a stock purchase, the buyer indirectly acquires all of the assets and liabilities of the target company. While post-closing indemnification by the sellers for pre-closing liabilities may be available in some types of mergers and stock deals, it typically provides only limited protection to the buyer. Accordingly, buyers often prefer to structure health care transactions as an asset purchase, which generally enables the buyer to leave behind expensive or indeterminate liabilities of the target business and to assume only those liabilities specified in the asset purchase agreement.

However, an asset purchase of a licensed health care facility that provides health care services to Medicare and Medicaid beneficiaries may not be practical, or even possible. Accordingly, acquisitions

of hospitals and other licensed health care facilities, especially those operated by nonprofit corporations, are often structured as a merger in which all of the assets and liabilities of the target company, including unknown and contingent liabilities, are transferred to the surviving company by operation of law. Alternatively, where the target is operated by a for-profit corporation, the transaction is often structured as a stock purchase, whereby the buyer indirectly acquires all of the assets and liabilities of the target company. These considerations make it especially important for the buyer to focus on the scope and duration of the seller's post-closing indemnification obligations.

On the other hand, if the target does not require a state license to operate, an asset deal may allow the buyer to reduce the risk of inheriting unknown liabilities attributable to the pre-closing actions of the seller. For example, the operation of a physician's office or a multi-specialty practice plan (without more) typically does not require a state license. Similarly, many states do not require the licensure of various ancillary services (for example, diagnostic imaging facilities). In such cases, careful attention to the definitions of "acquired assets" and "acquired liabilities," combined with requirements for the seller to maintain tail insurance, can result in avoidance of most types of successor liability.

One major exception is the successor liability imposed by Medicare/Medicaid. To date, courts have generally enforced this type of successor liability imposed on buyers by regulation, regardless of the parties' efforts to contract their way around it.

EXAMPLE: In a transaction involving the acquisition of a dental practice management company, the buyer typically will not be able to leave behind the target company's potential civil and criminal liability for violations of health care fraud and abuse laws. These liabilities will be automatically imposed on the buyer pursuant to program regulations, even if the transaction is structured as an asset purchase.

Similarly, a buyer may prefer to structure an acquisition of a medical device manufacturer as an asset deal in order to avoid assuming liability for pre-closing product liability claims. Also on the asset side, acquisitions of medical practices by hospitals are typically structured as asset transactions, in part in order to enable sellers to retain cash, accounts receivable, and certain other assets, thus eliminating the need for a complicated working capital adjustment.[9]

Obviously, structuring a health care acquisition as an asset transaction will not be feasible unless, in addition to addressing the risk allocation issues discussed above, this structure also enables the parties to achieve their commercial, tax, regulatory, deal execution, and other objectives. If any of these factors makes an asset purchase on the whole impracticable, the buyer may need to rely on post-closing indemnification provisions for protection from the target's pre-closing liabilities.[10]

Q 1.6.2 What are the tax implications of structuring the transaction as a stock or asset deal?

Where the parties are taxable organizations,[11] both an equity deal and an asset deal may be structured to be tax-free or taxable. The distinguishing feature is that a tax-free deal requires that the buyer use its own stock to effect the acquisition; in a taxable deal, cash or other property is used. The most important factors informing the tax-free versus taxable decision are:

- Does the buyer wish to use (and is it capable of using) its own stock to effect the acquisition?
- Will the buyer obtain a step-up in tax basis of the target assets by effecting a taxable acquisition, or will there be a step-down?
- Will a taxable acquisition result in taxes both at the target corporate level as well as the target shareholder level?
- Will a taxable acquisition cause the target to lose valuable tax attributes (such as loss carry-forwards)?

Tax-free equity deals may take many forms, but the most common is the reverse triangular merger in which the corporate buyer forms

a transitory merger subsidiary, which merges into the target, with the target surviving. Target shareholders, by operation of law, receive the right to a specific number of buyer shares in exchange for target shares, and the target becomes a wholly owned subsidiary of the buyer. Such a transaction is generally tax-free both to the target and the target shareholders. There is no step-up or step-down in the tax basis of the target's assets, and target shareholders carry their basis in target shares over to the buyer shares they receive in the merger. Net operating loss and tax credit carryovers of the target are preserved, but their use may be limited following the transaction.

An asset acquisition may also be effected in a tax-free manner. A typical tax-free asset transaction is a forward triangular merger, in which the target company merges into a direct subsidiary of the buyer, with the subsidiary surviving and the target disappearing. Target shareholders receive the right to a specific number of the buyer's shares. The tax results to the target and target shareholders are essentially the same as in the case of the tax-free equity deal described above.

An equity deal and an asset deal may each be effected as a taxable transaction by choosing nonstock consideration or altering the format of the acquisition. In order to effect a taxable equity deal, a buyer would typically use the reverse triangular cash merger structure, in which the buyer forms a transitory merger subsidiary that either borrows cash or receives an infusion of cash from the buyer. The merger subsidiary then merges into the target, with the target surviving. Target shareholders receive the right to cash consideration, and the target becomes a subsidiary of the buyer. Such a transaction is taxable to the target shareholders, but not to the target. The target's basis in its assets remains unchanged, but its tax carryovers may be limited. Such a taxable equity deal could be made taxable to the target through an election known as a section 338 election. If such an election is made, the target is deemed to sell all of its assets and repurchase them, but only for tax purposes.

Why would such an election be advantageous? If the target's assets are appreciated, the election will cause the target's asset basis to be stepped-up to market value (assuming the acquisition price is based on the market value of the target's assets), and thereafter the target

may depreciate its assets as if they were newly purchased. However, the target would be required to pay tax on the step-up, and since the depreciation deductions are recognized over time, but gains taxes are payable up front, such an election would seem to be disadvantageous. Moreover, because target shareholders are taxable on the cash they receive, the election would result in tax both at the target level and the shareholder level.

Nevertheless, there are particular circumstances where such an election would be advantageous. For example, if a target had large loss carry-forwards that were to expire soon, the election could be advantageous because the carry-forwards could offset most of the taxable income. As another example, if a target is an "S" corporation (a type of corporation that generally passes through corporate tax consequences to its shareholders), a sub-election could be made (a section 338(h)(10) election) that would cause gain at the target level, but such gain would be pass through to shareholders, often without adverse effects on such shareholders (because the pass through of the gain has a favorable effect on their basis in their target shares). Finally, if the target's selling shareholder is a corporation that consolidates with the target for tax purposes, the section 338(h)(10) election could be made, with the effect that the seller would bear solely the tax on the assets step-up, which may be equal to or less than the tax the seller would have paid on the sale of target stock without the election.

A taxable equity deal coupled with a section 338 election is often the most convenient structure for achieving a step-up in the target's asset basis because the buyer can achieve the same tax results that would have resulted from a direct, taxable assets acquisition, but without the asset conveyancing issues that arise in a true assets acquisition. Nevertheless, if a section 338 election is unavailable, or if it is desirable for the target to disappear as a legal entity, the transaction may be structured as a straight taxable assets acquisition. A typical structure would be the forward triangular cash merger, in which the buyer forms a subsidiary into which the target merges, with the subsidiary surviving and the target disappearing. Target shareholders receive the right to cash in exchange for their target shares. For tax purposes, such a transaction will have essentially

the same tax results as in the case of a taxable equity deal coupled with a section 338 election (or a section 338(h)(10) sub-election).[12]

Q 1.6.3 How does the transaction structure affect the need to obtain regulatory approvals and third-party consents?

Health care M&A transactions—whether structured as a stock purchase, merger, or asset purchase—typically require approvals by various state and federal governmental entities as well as the consents of third parties that have contracts with the target company. While some governmental approvals and third-party consents required with respect to the acquisition itself generally will not depend on the form of transaction (for example, a Hart-Scott-Rodino premerger filing,[13] if the transaction meets the applicable thresholds), others will require at least notice and sometimes consent. Some approvals, such as state licenses to operate a hospital or other form of health care facility may not themselves be sold or transferred as an asset. In general, a stock purchase or merger will typically require fewer such consents than an asset purchase, since the target's corporate identity and most of its regulatory licenses and permits will be unaffected by the transaction.

PRACTICE TIP: A stock purchase or merger (if the target is a surviving company) generally will not constitute a change of ownership of a hospital for purposes of the Medicare program. Accordingly, if leaving behind the target's liabilities is not a major concern for a buyer, the buyer may want to structure the transaction as a stock purchase in order to quickly assume the target's existing Medicare provider numbers, thereby avoiding a gap or delay in receiving Medicare payments. Similarly, a stock purchase or a merger where the target is a surviving company typically will not trigger anti-assignment provisions in the target's commercial and other contracts.

In contrast, in an asset purchase, the parties may be required to obtain numerous regulatory approvals and third-party consents to transfer to the buyer the licenses and permits necessary to operate the acquired business and to assign to the buyer the contracts of the acquired business.

In transactions involving hospitals, the transfer of substantially all of a hospital's assets will be considered a change of ownership of the hospital by the Medicare program. As a result, the buyer automatically assumes the seller's existing provider number and provider agreement unless the buyer expressly rejects the assumption, in writing, filed with the agency.

Moreover, as noted above, many permits (for example, a state license to operate a hospital) are not transferable even with consent. Thus, in an asset acquisition, the buyer may need to apply for and obtain a new license to operate the acquired business post-closing.

EXAMPLE: A hospital acquisition in California structured as an asset purchase will require the filing of a hospital license application with the California Department of Public Health, as well as compliance with certain other state licensure requirements.

In addition, many commercial contracts, including contracts with health care providers and third-party payors, and most real property leases may not be assigned without the consent of the parties. As a result, despite the benefits of the asset purchase structure, structuring a health care acquisition as a stock purchase or merger may be unavoidable if the target's key licenses, permits, contracts, and leases cannot be transferred in an asset structure.

PRACTICE TIP: Often, certifications by an accrediting organization, such as the Joint Commission,[14] cannot be assigned or even "carried forward" pending a post-closing inspection, without prior notice and approval. This detail can be particularly important where the seller has relied on such an accreditation to be "deemed" in compliance with the Medicare conditions of participation.

Q 1.6.4 What are relevant documentary considerations?

The primary advantage of a stock deal is its simplicity. In many stock transactions, the only items that need to be transferred at the closing are stock certificates representing the acquired shares. Similarly, no transfer documentation other than a certificate of merger is required in a merger—once the merger becomes effective, all of the assets and liabilities of the target are transferred to the surviving entity automatically by operation of law.

The transfer mechanics in a transaction structured as an asset purchase are generally more complicated than those in stock deals or mergers. The acquired assets and liabilities will need to be specifically transferred to the buyer, which may require extensive transfer documentation. Although most tangible assets typically can be transferred pursuant to a single bill of sale, individual instruments will be required to transfer to the buyer certain other acquired assets, such as real property, contracts and leases, intellectual property, vehicles, etc. These technical considerations may raise important commercial issues in certain transactions (for example, in a hospital acquisition that involves a significant amount of owned real property).

Notes to Chapter 1

1. For discussion of license and collaboration agreements, joint ventures and strategic alliances, see chapters 4, 39, and 40.

2. In the ten states with the highest percentage of nonprofit community hospitals, this percentage ranges from 85.7% (Delaware and New Hampshire) to 100% (Vermont). *See* Report of the Kaiser Family Foundation, http://kff.org/other/state-indicator/hospitals-by-ownership (based on 2012 data compiled by the American Hospital Association).

3. Special issues arising in acquisitions of nonprofit entities are discussed in more detail in chapter 8.

4. A 2013 ruling by the Delaware Court of Chancery in a case arising from the acquisition by the health care conglomerate Roche Holding Ltd. of BioVeris Corporation in 2007 reaffirmed the long-standing belief among M&A practitioners that the acquisition of a target company through the popular "reverse triangular merger" structure does not result in the assignment of the contracts of the target by operation of law or otherwise and will not trigger anti-assignment provisions that do not expressly prohibit a change of control. Meso Scale Diagnostics, LLC v. Roche Diagnostics GMBH, C.A. No. 5589-VCP (Del. Ch. Feb. 22, 2013).

5. *See* DEL. GEN. CORP. LAW § 251(h) (effective August 1, 2013, as further amended effective September 1, 2014).

6. These restrictions are discussed in greater detail in chapter 36.

7. Licensing agreements are discussed in more detail in chapters 4 and 39.

8. CVRs are discussed in more detail in chapter 2.

9. See chapter 3 for a discussion of working capital adjustments and other types of purchase price adjustments used in health care M&A transactions.

10. See chapter 38 for a discussion of indemnification provisions in health care acquisition agreements.

11. Tax considerations arising in connection with a transaction where both the buyer and seller are tax-exempt are discussed in more detail in chapter 8.

12. For further discussion of tax considerations in structuring health care M&A transactions, see chapter 13.

13. For discussion of the premerger notification requirements under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, see chapter 9.

14. The Joint Commission (TJC), formerly known as the Joint Commission on Accreditation of Healthcare Organizations (JCAHO), is a U.S.-based nonprofit organization that accredits health care organizations and programs in the United States.