PRIVATE EQUITY DEALMAKERS GUIDEBOOK TO HEALTHCARE M&A DURING THE COVID-19 PANDEMIC

OCTOBER 2020

BASS BERRY SIMS

CENTERED TO DELIVER.

TABLE OF CONTENTS

PRIVATE EQUITY DEALMAKERS GUIDEBOOK TO HEALTHCARE M&A DURING THE COVID-19 PANDEMIC

The COVID-19 pandemic has stressed the M&A market at every stage of the deal-making process – from complicating on-site visits and intensifying the diligence process to introducing valuation gaps (relative to pre-COVID-19 expectations), complicating purchase agreement negotiations and limiting the availability of debt financing. Despite these hurdles, healthcare dealmakers have continued to pursue attractive acquisition opportunities throughout 2020, with the healthcare M&A market substantially rebounding in many sectors since July. We expect this trend and activity to continue at least through year-end.

This guidebook is intended to provide a deeper dive into COVID-19-related transactional matters for private equity buyers or platforms to consider, including in connection with the evaluation of a target's receipt of stimulus funds under the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act) and the negotiation of key deal terms in the acquisition agreement. You may consult any of the authors listed below for more information, as well as your regular Bass, Berry & Sims contacts.

GENERAL CONSIDERATIONS IN BUY-SIDE DILIGENCE

A buyer in this market should be especially proactive about identifying and addressing COVID-19-related risks and potential deal complications relating to the target's receipt of stimulus funds under the CARES Act, including loans under the Paycheck Protection Program (PPP) and payments from the Public Health and Social Services Emergency Fund (HHS Provider Relief Fund).

A buyer's initial due diligence efforts should accomplish the following:

1. Assess the target's financial condition (including receivables, working capital and liquidity), performance and prospects in light of the continuing COVID-19 pandemic.
2. Identify the impact of COVID-19 on the target's business, including its vendors and customers.
3. Evaluate the target's response to the COVID-19 pandemic.
4. Identify the target's receipt of government assistance under any of the following programs:
    a. PPP.
    b. Economic Injury Disaster Loan (EIDL).
    c. Main Street Lending Program (MSLP).
    d. HHS Provider Relief Fund.
    e. Centers for Medicare & Medicaid Services (CMS) Accelerated and Advance Payment Program (Medicare Advances).
    f. Payroll tax deferral under the CARES Act.
    g. Employee retention tax credit under the CARES Act.
    h. Paid leave tax credits under the Families First Coronavirus Response Act (FFCRA).
5. Evaluate potential deferred tax liabilities (or potential loss of deductions for expenses covered by forgiven PPP loans) on the one hand, or potential tax benefits available due to CARES Act provisions allowing businesses to carry back net operating losses (NOLs).

Annex A to this guidebook sets forth an illustrative list of topics to consider in buy-side diligence in relation to the impact of COVID-19 on the target's business and the target's response to the COVID-19 pandemic.

SPECIFIC CONSIDERATIONS RELATED TO COVID-19 RELIEF PROGRAMS

Paycheck Protection Program

For sellers whose businesses have availed themselves of PPP loans, the prospect of potential loan forgiveness can represent a substantial economic impact. Accordingly, sellers are frequently approaching M&A transactions hoping and expecting to obtain the economic benefit of PPP loan forgiveness in addition to the purchase price paid by the buyer.

Once a buyer learns that a target has obtained a PPP loan, the buyer should confirm the original principal amount of the loan, the date that the target received the PPP loan proceeds, the "covered period" (*i.e.*, eight or 24 weeks) applicable to the target's PPP loan, and the status of the target's forgiveness application in order to make an initial assessment of the impact of the target's PPP loan on the proposed transaction and the likely outcome and timing of a forgiveness determination. A buyer should carefully evaluate the target's compliance with applicable law in relation to a PPP loan as well as other risks associated with the target's participation in the PPP, but in many circumstances, it may be feasible for the seller to retain the benefit of PPP loan forgiveness following the closing.

Considerations Applicable to PPP Loans Not Repaid or Forgiven Prior to Closing

Buyers should recognize that, even if ultimately forgivable, a PPP loan is debt unless and until forgiven. If forgiveness will not be pursued, the PPP loan should be treated as ordinary debt and paid off at the closing. However, as noted above, many sellers are approaching deals with the expectation that they will reap the benefit of PPP loan forgiveness. If forgiveness has not yet been granted and the buyer is willing to pursue forgiveness post-closing (rather than requiring the PPP loan to be paid off at closing), this will create some complications for the parties that must be addressed.

In most transactions, those complications will include a lender consent. Most PPP loan documents prohibit changes in ownership of a PPP borrower without the lender's consent, and the U.S. Small Business Administration (SBA) has prohibited PPP lenders from consenting to "change of ownership" transactions without SBA approval unless certain conditions are satisfied. If the target's PPP loan has not already been forgiven or repaid in full, the buyer should review the applicable promissory note and any other loan documents to determine whether lender consent will be required in connection with the applicable transaction. (However, even if the PPP loan documents do not require lender consent to the proposed transaction, the buyer and seller should consider satisfying the conditions described below to provide assurance that SBA approval of the proposed transaction would not be required.)

The SBA will consider a "change of ownership" of a PPP borrower to have occurred if (1) at least 20% of the common stock or other ownership interest of a PPP borrower is sold or otherwise transferred, whether in one or more transactions, including to an affiliate or an existing owner of the entity, (2) the PPP borrower sells or otherwise transfers at least 50% of its assets (measured by fair market value), whether in one or more transactions, or (3) a PPP borrower is merged with or into another entity. For purposes of determining a change of ownership, all sales and other transfers occurring since the date of approval of the PPP loan must be aggregated to determine whether the relevant threshold has been met.

If any portion of the PPP loan remains outstanding as of the closing of a change of ownership transaction, the PPP lender may consent to the change of ownership without SBA approval only in one of the following circumstances:

1. The change of ownership is structured as a sale or other transfer of common stock or other ownership interest, and the sale or transfer is of 50% or less of the common stock or other ownership interest of the PPP borrower.

2. The borrower completes a forgiveness application reflecting its use of all of the PPP loan proceeds and submits it, together with any required supporting documentation, to the PPP lender, and an interest-bearing escrow account controlled by the PPP lender is established with funds equal to the outstanding balance of the PPP loan, to be held for the purpose of paying off the PPP loan to the extent that forgiveness is denied.

If the PPP lender consents to a change of ownership without SBA approval in any of the circumstances described above, the PPP lender must notify the appropriate SBA Loan Servicing Center, within five business days of completion of the transaction, of (1) the location of, and the amount of funds in, the escrow account and (2) if the change of ownership is structured as a sale or other transfer of common stock or other ownership interest or as a merger, certain information about the new owner(s) of the business.

If the SBA's approval of a change of ownership is required (because the conditions described above are not satisfied), the PPP lender will be required to submit to the appropriate SBA Loan Servicing Center certain materials regarding the buyer, the seller and the proposed transaction, including any letter of intent and the purchase or sale agreement. The SBA will review and provide a determination within 60 days of receipt from the PPP lender of the required materials. As a condition to approving any change of ownership, the SBA will require the purchasing entity to assume all of the PPP borrower's obligations under the PPP loan.

In order to timely navigate the lender consent process, most M&A transactions involving a PPP loan likely will be closed under the SBA-sanctioned circumstances described above – *i.e.*, with the borrower having submitted to the PPP lender a forgiveness application reflecting its use of all of the PPP loan proceeds and funded an escrow account controlled by the PPP lender in an amount equal to the outstanding balance of the PPP loan. This escrow should help protect the buyer from risks related to the potential post-closing denial of forgiveness (including a requirement to immediately repay the PPP loan with interest), but the buyer also should ensure that the acquisition agreement includes an appropriate framework for addressing PPP forgiveness-related matters post-closing. The buyer should consider potential costs that may be incurred in responding to SBA inquiries during the initial forgiveness review (especially for loans over $2 million) and seek to limit any express or implied obligations to seek loan forgiveness for the benefit of the sellers (including, as applicable, through the use of an appropriate efforts standard).

If the buyer already has a PPP loan of its own, it should keep those funds segregated, clearly delineate PPP-authorized expenses of the buyer from expenses of the acquired PPP borrower, and document the compliance of each PPP borrower with applicable PPP requirements.

The buyer also should consider the implications of the target's PPP loan under the buyer's existing credit facilities. If the target's PPP loan will remain outstanding following the closing at a buyer subsidiary level, the buyer should confirm that this subsidiary-level loan would not violate its existing loan covenants.

Considerations Applicable to All PPP Loans

Even if the target's PPP loan has been forgiven and/or repaid in full prior to the closing, the buyer should recognize that the PPP borrower will continue to have exposure for, *e.g.*, false or misleading statements made (including in certifying as to the borrower's eligibility) in connection with obtaining a PPP loan or the use of PPP loan proceeds for prohibited purposes. Accordingly, regardless of the status of the PPP loan as of the closing (*i.e.*, forgiven, repaid or outstanding), the buyer's diligence should include a detailed analysis of the target's eligibility to obtain a PPP loan, the accuracy of the target's PPP loan application, the target's use of the PPP loan proceeds and related documentation and recordkeeping, and the accuracy of the target's forgiveness application (if already submitted). Annex B to this guidebook sets forth a more detailed description of certain due diligence considerations related to PPP loans.

In evaluating the risk profile of a given PPP loan, the buyer should carefully assess the various sources of post-closing exposure (other than repayment with interest) related to the target's PPP loan, including the consideration of:

1. Costs incurred in responding to subsequent audits or investigations by the SBA, the Special Inspector General for Pandemic Recovery (SIGPR), the Department of Justice (DOJ), the Securities and Exchange Commission (SEC), Congress or other governmental authorities.
2. Civil penalties and damages (including potentially punitive or treble damages), criminal charges and defense costs resulting from enforcement actions pursued by law enforcement agencies or *qui tam* relators, including claims alleging fraud and/or False Claims Act violations.
3. Failure to comply with the obligation to retain "all records relating to the [b]orrower's PPP loan, including documentation submitted with its PPP loan application, documentation supporting the [b]orrower's certifications as to the necessity of the loan request and its eligibility for a PPP loan, documentation necessary to support the [b]orrower's loan forgiveness application, and documentation demonstrating the [b]orrower's material compliance with PPP requirements."
4. Reputational harm and similar risks related to participation in the PPP (which may be particularly heightened if the PPP loan remains outstanding as of the closing and the buyer will be the owner at the time of PPP forgiveness, even if the buyer did not own the borrower at the time of loan application and is passing 100% of the forgiven amount through to the seller).

All else being equal, the enforcement risk can be expected to increase with the size of the PPP loan, and buyers of businesses with larger PPP loans should take this into account, particularly where the original principal amount of the target's PPP loan exceeds $2 million, as such loans will be subject to heightened review by the SBA.

Buyers should also note the impact of transaction structure on its PPP-related exposure. In a stock sale or merger, any risk associated with the target's PPP loan will remain with the target entity, which would impact the buyer post-closing. However, in a transaction structured as an asset sale where the PPP loan remains with the seller entity, the entity-level risk associated with that PPP loan should remain with the seller. In a physician services/MSO structure, buyers who can simply acquire assets from a seller practice entity and integrate those assets into an existing practice entity (and therefore do not need the seller practice as a friendly PC in the go-forward structure) may have an opportunity to avoid potentially meaningful post-closing exposure that could impact buyers who need to use the seller practice entity to expand into new markets.

The buyer should ensure that the indemnification provisions in the acquisition agreement appropriately preserve its rights to control the target's response to SBA or other governmental inquiries, audits, investigations and enforcement actions. The buyer should also consider insisting upon a dollar-one specific indemnity for any losses arising from the target's participation in the PPP, including without limitation the target's eligibility to obtain a PPP loan, statements made in the loan application or forgiveness application, and the target's use of proceeds.

Other CARES Act Loan Programs

Although less common, buyers also should understand the implications of a target having received an EIDL or MSLP loan. Neither of these loan programs offers forgiveness, so outstanding loan obligations should be treated similarly to any other indebtedness in the transaction. However, as federal government loan programs, both EIDL and MSLP loans implicate many of the same post-closing compliance and enforcement risks discussed above concerning PPP loans.

Additionally, subject to certain limitations, an MSLP borrower is prohibited from either of the following:

1. Repurchasing an equity security of the borrower or its parent company listed on a national securities exchange.
2. Paying dividends or making other capital distributions with respect to common stock or equivalent interests in a partnership, limited liability company, or other legal entity, in each case within 12 months after the date on which the MSLP loan is paid off.

During the same period, MSLP borrowers also must comply with certain compensation restrictions applicable to employees who earned total compensation over $425,000 in 2019.

HHS Provider Relief Fund

The HHS Provider Relief Fund was created to help healthcare providers and suppliers respond to the COVID-19 public health emergency. Through the program, HHS was tasked with distributing $175 billion to hospitals and healthcare providers, and operating a reimbursement program for those providing COVID-19-related testing and treatment to the uninsured.

Despite initially being touted as "no strings attached" funding, there are several terms and conditions that apply to the receipt and use of distributions from the HHS Provider Relief Fund. As part of accepting the funds, recipients are required to certify that certain terms and conditions have been met, including, among other things, that the recipient treated patients after January 31, 2020, that the funds will be used only to support COVID-19 attributable expenses and cover COVID-19 attributable losses, and the funds will not be used to pay any individual at a rate above $197,300.

Also, the recipient agrees to comply with documentation and reporting requirements; agrees not to balance bill any out-of-network patient for COVID-19-related treatment; and certifies that all information it provides is true, accurate and complete. Notably, the recipient also must acknowledge that any deliberate omission, misrepresentation or falsification of any information provided to HHS concerning the HHS Provider Relief Fund may be punishable by criminal, civil or administrative penalties, including but not limited to revocation of Medicare billing privileges; exclusion from federal healthcare programs; and/or the imposition of fines, civil damages, and/or imprisonment; as well as subject the recipient to potential False Claims Act liability, which can result in treble damages.

Buyers should be prepared for a retrospective review of any funds received by targets from the HHS Provider Relief Fund, with the level of the review being proportional to the amount of funding received. Both HHS and the Office of Inspector General (OIG) have clearly signaled as much. In fact, the OIG is in the process of updating its enforcement authority concerning these types of HHS grants. Liability for failure to comply with the terms and conditions will fall to the legal entity and Medicare provider that received the funds; and, of course, with respect to certified suppliers (*e.g.*, ASCs) and providers (*e.g.*, hospitals, home health, etc.), even in an asset sale transaction Medicare liability flows to the buyer if it succeeds to the seller's Medicare provider number.

In the context of an asset deal, HHS has made clear that any funds not expended for appropriate COVID-19 attributable expenses and losses by the seller before the transaction must be repaid to HHS; the funds may not be transferred to the buyer. It is possible, however, for repercussions for any inappropriate receipt or use of funds by the seller to potentially jeopardize the Medicare enrollment that is transferred as part of the transaction.

To protect its investment, a buyer should evaluate the target's compliance with the terms and conditions of receiving this funding, including obtaining and reviewing supporting documentation. The buyer's diligence should include a review of the target's eligibility to receive each distribution it has received (or applied for) from the HHS Provider Relief Fund, verification of the amounts received (or expected) and identification of the type of distributions (*i.e.*, "general distributions" or "targeted distributions"), and verification that the target has adequate documentation to demonstrate its appropriate use of the funds and support its compliance with the terms and conditions. Not only is this important to confirm that the target has not used such funds in violation of, or otherwise failed to comply with, the HHS Provider Relief Fund terms and conditions; it also is important because the buyer likely will need to ensure that it has sufficient information to comply with future HHS reporting requirements (and to apply for future funds, as applicable). If a buyer is not able to appropriately support the use of the funds through reporting, it likely will result in the need to make a future repayment.

If there are any HHS relief funds not yet utilized by the legal entity that received them, the buyer should establish a process to ensure those funds stay with that legal entity and continue to be used for permissible purposes.

Buyers should consider excluding from cash and working capital calculations (or ensuring that closing net working capital includes an offsetting current liability for) the amount of any grants from the HHS Provider Relief Fund except to the extent that the target can satisfactorily demonstrate that such funds have been used per the HHS Provider Relief Fund terms and conditions. To the extent that a buyer is not confident in its ability to defend the target's use of funds in an audit situation or complete the required reporting expectations, the buyer should consider this in evaluating how proceeds received by the target from the HHS Provider Relief Fund should be treated in the transaction.

Buyers also should include representations and warranties in the acquisition agreement regarding the target's pre-closing compliance with the terms and conditions of receiving the funding and accuracy of the data necessary for outstanding reporting expectations. Buyers should consider making these representations fundamental or otherwise carving them out of any baskets or caps. Buyers also may consider proposing a separate, dollar-one specific indemnity (that would not be limited by any survival period) to protect against any losses arising from the target's noncompliance with the HHS Provider Relief Fund terms and conditions.

The seller may object to providing an indemnity to the extent that the scope of such indemnity could provide coverage for losses arguably incurred by the acquired entity after the closing (*e.g.*, in connection with the utilization of proceeds from the HHS Provider Relief Fund for post-closing losses or expenses). However, the buyer should consider requiring the seller's indemnity to explicitly cover any losses arising from claims or investigations regarding pre-closing losses and/or expenses for which the seller retains the economic benefit of the HHS Provider Relief Fund assistance.

Medicare Advances

To the extent received and not yet recouped, Medicare Advances generally should be recorded as deferred revenue on the target's balance sheet. Medicare Advances could be treated either as debt or included in the calculation of net working capital as a current liability. If treated as a component of net working capital, buyers should be careful to exclude any Medicare Advances from any calculations based on historical working capital levels used to set the working capital target.

Tax Relief

The CARES Act also includes several tax relief programs to assist businesses in weathering the COVID-19 pandemic, including payroll tax deferral; the employee retention tax credit; and the revival of a five-year carryback for net operating losses earned in 2018, 2019, or 2020. Each of these programs could impact M&A transactions in different ways.

The CARES Act permits employers to defer the deposit and payment of the employer's portion of social security taxes that otherwise would be due between March 27, 2020, and December 31, 2020. Half of any deferred amounts would be payable on December 31, 2021, and the other half would be payable on December 31, 2022. Where a target has availed itself of this payroll tax deferral, the buyer should confirm that this deferral has been properly recorded as a liability on the target's balance sheet. Any deferred payroll tax obligations related to the pre-closing period should be treated as debt in the acquisition agreement or otherwise reduce purchase price on a dollar-for-dollar basis. Buyers also should consider any EBITDA impacts of deferred payroll tax in the target's historical financials.

The CARES Act also provides for a refundable tax credit, known as the employee retention tax credit, that provides temporary wage support to certain employers impacted by the COVID-19 pandemic, and the FFCRA provides for refundable tax credits that reimburse eligible employers for the costs of providing paid leave to covered employees under the FFCRA. If a target has claimed the CARES Act employee retention tax credit or the FFCRA paid leave tax credit, a buyer should review the target's eligibility for these tax credits, ascertain the dollar amount claimed and received, and ensure that the acquisition agreement provides indemnification to the buyer if these credits were improperly claimed with respect to pre-closing periods.

The CARES Act also allows taxpayers to carryback NOLs generated in taxable years beginning after December 31, 2017, and before January 1, 2021, for up to five years. The Tax Cuts and Jobs Act (TCJA), enacted in December 2017, had eliminated NOL carrybacks, but under the CARES Act, corporate taxpayers may amend prior-year tax returns to offset taxable income from those tax years with NOLs generated in 2018, 2019 or 2020. This NOL carryback could generate a meaningful tax refund for, *e.g.*, a corporate taxpayer with 2020 tax losses that can be carried back to 2015 and offset prior year income that had been taxed at the pre-TCJA corporate rate of 35%. Buyers and sellers should be sensitive to these potential tax benefits and, where applicable, appropriately address in the acquisition agreement the allocation of the economic benefit of any NOL carryback and procedural matters regarding the amendment of prior year tax returns to carryback the NOLs.

Participation in Multiple Relief Programs

Where a target has availed itself of multiple COVID-19 relief programs, a buyer should carefully evaluate the target's eligibility to participate in each program and consider the implications on the overall risk profile of the target's participation in these programs. Private equity buyers also should consider any impact of the target's participation in COVID-19 relief programs on their other portfolio companies (*e.g.*, if the target obtained a PPP loan and other portfolio companies have availed themselves of the employee retention tax credit).

Participation in certain relief programs is restricted or limited based on participation in certain other of these programs. The employee retention tax credit, for instance, is not available to PPP borrowers. Additionally, although a borrower is eligible to receive both an EIDL and a PPP loan, the proceeds of each loan must be used for different expenses, and a borrower who received both a PPP loan and an emergency EIDL grant under Section 1110 of the CARES Act will have its PPP forgiveness amount reduced by the amount of such EIDL grant.

More broadly, buyers should confirm in diligence that the target has not "double-dipped" by using funds from multiple sources (*e.g.*, PPP loan proceeds, general distributions from the HHS Provider Relief Fund, targeted distributions from the HHS Provider Relief Fund) to cover the same expenses or losses.

Many lower middle market healthcare transactions may involve a target who has obtained a PPP loan and also received distributions from the HHS Provider Relief Fund. In such cases, buyers should be sensitive to potentially heightened risk regarding the target's necessity certification in its PPP application where the target also received distributions from the HHS Provider Relief Fund.

Impacts on Closed Deals

Although this guidebook is focused primarily on M&A transactions occurring during the COVID-19 pandemic, dealmakers also should be aware of potential impacts of the COVID-19 pandemic and related government relief programs on previously closed transactions.

Earnouts, in particular, may be impacted materially by COVID-19. Dealmakers should be aware of any financial statement impacts of participation in COVID-19 relief programs and any implications for earnouts tied to metrics such as EBITDA. Buyers also should be sensitive to operational changes or budget, workforce or compensation reductions as these relate to any potential good faith or commercially reasonable efforts covenants agreed to in connection with any earnouts. To the extent the earnout is payable to key employees or business relations, the buyer may wish to find an agreeable work-around (*e.g.*, extensions, revised targets, etc.) to allow for a fair opportunity to fully achieve the earnout post-COVID-19.

Buyers and sellers also should consider the potential implications of the CARES Act's NOL carryback provisions on closed deals, given that post-TCJA acquisition agreements may not have contemplated the availability of such carrybacks.

KEY TERMS IN ACQUISITION AGREEMENTS

Earnouts/Contingent Payments

Buyers and sellers increasingly have turned to contingent payments as a means to bridge valuation gaps that have been exacerbated by the sudden shock of the COVID-19 pandemic. There is a compelling business case for earnouts in this market, but earnouts present many well-known challenges. Earnouts are not only difficult to negotiate – as parties haggle over performance metrics, operating covenants and treatment in the event of future M&A activity involving the company – but they also are famously ripe for post-closing disputes.

Sellers in the current market are loath to sell at severely discounted prices given the possibility of a relatively quick bounce back if the spread of COVID-19 can be brought under control. Meanwhile, in many subsectors, depressed revenues, combined with uncertainty as to when and how COVID-19 will be controlled or other COVID-19-driven market shifts, simply do not justify buyers paying the same prices today that they might have paid a year ago for the same asset. The nature of this misalignment suggests that, at least in certain deals, earnouts may be most effectively structured when tied to metrics or milestones indicating that performance has rebounded to pre-COVID-19 levels. And, although we are not seeing a decrease in multiples, we are seeing earnouts used to bridge valuation gaps between sellers and buyers related to pre- and post-COVID-19 performance. Regardless of how the earnout is structured, buyers agreeing to earnouts should seek to limit post-closing operating covenants and negotiate for an express right to offset indemnity claims against earnout payments.

As an alternative to (or perhaps in conjunction with) a traditional earnout, sellers with sufficient leverage may seek to bridge a portion of any valuation gap with a purchase price clawback that is triggered if specified metrics or milestones are not achieved. Other options for bridging divergent views of valuation include the use of performance-based seller notes and an increased amount of rollover equity.

As noted above with respect to earnouts in previously closed deals, buyers should consider carefully the impact of COVID-19 relief on targets' 2020 and 2021 financial statements (*e.g.*, EBITDA impact of PPP forgiveness) when structuring earnouts.

Further, earnouts involving potential referral sources and targets who receive payments from government payors need to be carefully structured with the assistance of regulatory counsel to stay clear of potential anti-kickback risks.

Net Working Capital Adjustments

Net working capital and similar purchase price adjustments are frequently the subjects of intense negotiations in M&A transactions. If anything, this is likely to be even more relevant over the next 12 to 24 months as businesses struggle to manage receivables and payables and account for various forms of government assistance.

Current market conditions have materially impacted many businesses' working capital levels and complicated the common practice of pegging target net working capital to a "normalized" historical level. Although the situation has stabilized, at least to some extent, for many businesses since the initial shock in March, this likely will continue to be a challenge for dealmakers, especially where the parties anticipate a longer period between signing and closing.

Buyers and sellers also should be mindful of the impact of COVID-19 relief programs on the target's financial statements and the treatment of various forms of government assistance as either debt, current liabilities accounted for in working capital, or cash for which the seller will retain the benefit. Recommendations regarding the treatment of many of these programs are more specifically discussed in the prior section of this guidebook.

Representations and Warranties

Buyers should consider seeking additional representations and warranties, or modifications to standard representations and warranties, to account for the impact of COVID-19 (COVID-19 Representations and Warranties). Many of the concerns addressed by these COVID-19 Representations and Warranties already may be covered by standard representations, such as customary representations regarding compliance with the law, the accuracy of financial statements, undisclosed liabilities, and the absence of changes. However, the inclusion of specific COVID-19 Representations and Warranties may aid in the buyer's due diligence efforts, as such inclusions may result in better disclosures relating to the target's business and more easily facilitate the treatment of certain COVID-19 Representations and Warranties as fundamental representations or otherwise subject to extended survival periods and/or carve-outs from any baskets or caps.

On the other hand, if the transaction involves a representations and warranties insurance (RWI) policy, it may be advantageous to both parties (in maximizing coverage under the RWI policy) to minimize COVID-19 Representations and Warranties to the extent that the matters to be addressed thereby are already covered by standard representations and warranties, as explicit references to COVID-19 are more likely to be flagged in underwriting. Additionally, certain COVID-19-related matters may be most efficiently addressed by modifying defined terms in the acquisition agreement rather than including additional representations (*e.g.*, including an explicit reference in the definition of indebtedness to payroll tax liabilities deferred under the CARES Act).

Some examples of specific COVID-19 Representations and Warranties that buyers should consider including in acquisition agreements include representations and warranties covering the following:

- Compliance with all laws and regulations related to COVID-19 in the workplace, which would include all requirements under OSHA, confidentiality, sick leave or family and medical leave or the FFCRA.
- Any business interruptions or material adverse effects arising out of or related to COVID-19.
- Any COVID-19 measures that may be affecting the target company's ordinary course of business operations (*e.g.*, no elective procedures, stay-at-home orders, etc.).
- Any changes in the operations of the business as a result of COVID-19, including any cost reduction measures implemented or planned by the target such as payroll reductions or changes to budgeted capital expenditures or marketing expenses.

- Any indications that vendors or customers or target will be unable to perform under any contract as a result of COVID-19 (including any mandatory shutdown orders).

Additionally, if the target has availed itself of COVID-19 relief under the CARES Act or other government programs, the buyer should consider including specific COVID-19 Representations and Warranties to reinforce its diligence on key matters such as the target's eligibility to participate in the applicable program(s) and compliance with program requirements. For instance, if the target received a PPP loan, appropriate COVID-19 Representations and Warranties may cover the following:

- The accuracy of all information presented and certifications made in the target's PPP loan application.
- Historical employee census and payroll data to support the calculation of the target's maximum PPP loan amount and, if applicable, PPP loan forgiveness.
- Itemized disclosure of the target's use of PPP funds.

Refer to the prior section of this guidebook for a more detailed discussion of the treatment in an acquisition agreement of certain COVID-19 government relief programs.

Covenants

To the extent that there is an interim period between the signing of an acquisition agreement and the closing of the transaction, the parties should carefully consider, in light of the COVID-19 environment, the seller's and target's interim period covenants regarding the continued operation of the business. For example, many sellers seek to include specific COVID-19 qualifications (*e.g.*, responding to any "shelter in place" or similar government orders; potential shutdown of facilities; incurrence of debt; potential adjustments to accounting policies, including delaying of payment of accounts payable, and revisions to budgets and projections; termination or furloughing of employees; and similar measures) to the seller's and target's obligations to operate the business in the ordinary course during the interim period. These qualifications permit the seller and target to quickly respond to any COVID-19-related issues during the interim period without fear of a potential breach of the acquisition agreement. Buyers, on the other hand, may resist such carve-outs and require an approval right for any such COVID-19-related measures taken by the seller or target to ensure that the target purchased at closing is substantially the same as, if not identical to, the target that buyer agreed to purchase at the signing.

Buyers also should be alert as to what is meant by the seller's and target's obligations to operate the business in the "ordinary course of business consistent with past practice" or similar qualifications during the interim period – due to the ongoing COVID-19 pandemic, these qualifications could be construed to include the seller's and target's previous responses to COVID-19 (rather than the seller's and target's pre-COVID-19 operation of the business). To clarify any such provisions, buyers often seek to define "ordinary course" operations to specifically carve out any changes due to COVID-19 measures and any other actions or responses to COVID-19.

In addition to the foregoing, buyers and sellers also should consider any COVID-19-related impacts on other typical interim covenants, including, for example, potential delays in obtaining necessary third-party or governmental consents or approvals (*e.g.*, HSR clearance; landlord consents; customer or supplier consents), the certainty of securing any deal-related financing, and other similar requirements.

Closing Conditions

In transactions with bifurcated signing and closing structures, buyers and sellers should carefully consider the closing conditions in the transaction agreement, many of which could be significantly impacted by COVID-19.

Negotiation of closing conditions based on COVID-19 concerns may include both of the following:

1. How the material adverse effect (MAE) qualifier is defined.
2. The addition of COVID-19-targeted closing conditions.

The definition of MAE and its use throughout the agreement are heavily negotiated in an acquisition agreement as it may allow the buyer an "out" between signing and closing. In the wake of COVID-19, sellers often seek to exclude pandemics from the definition of MAE. Such exclusions will make it more difficult for a buyer to terminate the agreement in the event the seller's business performs worse than expected as a result of the pandemic. Buyers should seek to narrow the impact of the MAE pandemic exception by adding a "disproportionate effect" clause, such that a pandemic may constitute an MAE only if it has a disproportionate effect on the seller compared to other businesses in the same industry or the same geographic area.

Both parties should bear in mind that MAE is an extremely high bar and courts have rarely enforced it as a means for a buyer to terminate a transaction. Delaware courts, for example, find that an event will constitute an MAE if it "substantially threaten[s] the overall earnings potential of the target in a durationally-significant manner." Although MAE continues to be a heavily negotiated term in a transaction agreement, buyers should not rely on it alone as a means of allocating risk with respect to the conditions for each party to close.

Because the bar to enforce MAE is so high, buyers also should consider negotiating closing conditions that target specific operational or financial metrics of a seller who may be adversely affected in the wake of COVID-19. Such specific conditions may include:

- Conditions centered on the seller's defaults under specified key contracts (such as material customers or suppliers).
- Commencement of certain types of material litigation.
- Default by certain key vendors, or supply chain or distribution disruptions.
- Loss of key employees or other employee unavailability issues (due to stay-at-home orders, reductions in force or otherwise).
- Satisfaction or lack of satisfaction of financial metrics related to key contracts or termination of key contracts.
- Potential executive orders that could otherwise impair the business, especially if the company operates in COVID-19 "hot spots."

Finally, the parties should consider the standard condition that requires the seller to bring-down the representations and warranties – *i.e.*, certifying that the representations and warranties are true at closing. Essentially, a lower bring-down standard makes it easier for a buyer to walk away from the transaction. Sellers, however, likely will be concerned with the risk of a lower bring-down standard, given COVID-19's far-reaching and often unpredictable impact on operations. Such an impact could affect representations related to top customers and suppliers, normal business operations, and indebtedness, to name a few. The leverage provided by a bring-down condition (*i.e.*, to walk or to renegotiate the price or specific indemnities) may be the buyer's only hope to avoid being stuck overpaying for damaged goods.

Given the unpredictability of the COVID-19 environment, the parties should be particularly thoughtful about the potential for "interim breaches" (*i.e.*, events occurring between signing and closing that cause a representation or warranty to be breached) to arise. The parties should consider whether, and in what circumstances, it is appropriate for the seller to update its disclosure schedules in connection with the bring-down. In transactions involving RWI, the buyer in particular should consider the extent to which disclosure schedule updates could impair its ability to make claims for those matters post-closing under the RWI policy. A buyer also should keep in mind that it will have to bring-down its RWI no-claims declaration at closing, leading to policy exclusions to the extent that any interim breach has occurred.

Regardless of deal size or type, it is as important as ever for parties to carefully negotiate closing conditions in a transaction agreement to facilitate a successful closing.

Indemnification

In the current environment of uncertainty, parties are paying additional attention to the allocation of risks related to COVID-19 in M&A transactions. In the context of risk allocation through indemnification, many buyers are seeking to include COVID-19 Representations and Warranties in the "fundamental representations" or create a separate class of semi-fundamental COVID-19 representations, to extend the survival period of such representations and/or eliminate the applicability of certain indemnification caps or baskets to such representations. Additionally, especially where specific COVID-19-related risks or issues are identified during the due diligence process, some parties also are electing to include specific indemnification and/or escrow provisions related to COVID-19 matters, which has the further benefit of exempting related claims from any baskets or deductibles and potentially subjecting such claims to a higher cap.

These specific indemnification clauses can broadly include all COVID-19 matters, or specifically identified COVID-19 related risks of the target business, including personnel and patient health and safety claims, deferred taxes under the CARES Act, PPP loans (if not forgiven) and distributions from the HHS Provider Relief Fund, and the related escrow provisions set aside funds to cover losses related to such matters.

REPRESENTATIONS AND WARRANTIES INSURANCE

The RWI market seems to have generally kept pace with the broader M&A market through the COVID-19 pandemic, and, despite fears of increased claims, RWI premiums have remained generally stable. Although obtaining an RWI policy generally requires incrementally more work on the front-end for a buyer, and certainly added expense (even if the seller agreed to pay all premiums and underwriter diligence fees), having an RWI policy in place can shift a significant amount of risk off of both the buyer and seller and ultimately ease negotiations of the acquisition agreement.

However, the novel coronavirus has presented challenges for dealmakers in the RWI underwriting process. In the earlier stages of the COVID-19 pandemic, amidst tremendous market uncertainty, many underwriters were requiring broad exclusions for COVID-19-related losses. Over the past several months, however, underwriters largely have shifted to a more accommodating approach, tailoring the scope of COVID-19-related exclusions based on diligence. Most underwriters generally are still excluding from coverage any losses related to COVID-19 transmission at the target's facilities and PPP loan exposure, but some policies are now being written without any COVID-19-related exclusions at all.

Further, some RWI carriers have begun offering separate contingent risk policies providing coverage for certain PPP-related exposure. These policies were conceived in response to the general uncertainty surrounding the PPP, including the lack of SBA precedent regarding the interpretation of eligibility criteria, and are generally designed to cover certain risks related to the borrower's eligibility to obtain a PPP loan.

One of the most significant challenges of navigating the current RWI market is anticipating the scope of COVID-19-related exclusions at the critical point when the buyer must select an underwriter. Because buyers must make this decision (and pay a meaningful upfront fee) before an underwriter will begin its diligence, buyers never have perfect information about the scope and terms of coverage that would ultimately be offered by the competing underwriters. This makes an "apples to apples" comparison difficult in any deal, but the general stability of the RWI market has mitigated this concern in recent years. However, given the fluidity of both the COVID-19 pandemic and the appetite of insurers to underwrite

COVID-19-related risk in RWI policies, the buyer's choice of underwriter could have a more significant impact on the scope of important coverage than it has historically had in more stable environments. As always, buyers should consult with their RWI brokers and counsel in evaluating competing RWI proposals.

Additionally, as discussed above in the Closing Conditions section of this guidebook, in transactions involving RWI and bifurcated signing and closing structures, the parties should be particularly thoughtful about the potential for "interim breaches" (*i.e.*, events occurring between signing and closing that cause a representation or warranty to be breached) to impact RWI coverage.

GOVERNMENT INVESTIGATIONS IMPACT

In recent years, the DOJ expanded its enforcement activities and oversight under aggressive False Claims Act investigations to private equity firms, which increased compliance risks for funds and their holdings and provided potential fodder for future whistleblowers. The COVID-19 pandemic and its related financial assistance has only heightened the importance of compliance and the potential for government scrutiny of investments and acquisitions. The risk associated with each merger or acquisition has only expanded during this unprecedented situation.

The greater the level of involvement and control by private equity firms in their investments, the greater the potential exposure to government enforcement actions. Conversely, a hands-off approach by a private equity firm to a portfolio company could prove just as risky. Failure to sufficiently analyze the compliance proficiency and gaps of a target company could lead to potential liability. Private equity firms would be wise to anticipate an increase in government inquiries and whistleblower activity. It is important to take proactive measures at the time of due diligence and on an ongoing basis post-closing.

Several new government authorities are authorized to investigate pandemic-related compliance issues, including organizations tasked with overseeing the request, management, allocation, and use of CARES Act relief funds. The CARES Act created the following entities to monitor use of CARES Act funding until 2025:

1. The Pandemic Response Accountability Committee (PRAC) within the Council of Inspectors General on Integrity and Efficiency to prevent and detect fraud, waste, abuse and mismanagement related to COVID-19-related funds.
2. The SIGPR to audit and investigate loans, guarantees and investments made under the CARES Act.
3. The COVID-19 Congressional Oversight Commission (Commission) to review the management of $500 billion in relief funds by U.S. Department of the Treasury and the Federal Reserve Board, including transparency in the disbursement of funds, and report to Congress.

Additionally, existing enforcement agencies are reviewing CARES Act loans and spending. Such agencies and oversight bodies include the DOJ; U.S. Government Accountability Office (GAO); Internal Revenue Services' Criminal Investigation Division; Committees on Oversight and Government Reform, Energy and Commerce, and Financial Services; U.S. Senate; and Federal Bureau of Investigation (FBI).

Private equity firms must adapt to the new realities of doing business while facing an intense oversight landscape. Companies engaging in dealmaking during this period should consider the following best practices to mitigate these challenges:

1. Conduct a thorough pre-investment due diligence review to prevent against surprises that could draw government scrutiny or whistleblower activity later.
2. Ensure target companies have thoroughly and accurately documented their decisions related to use of CARES Act funding or other COVID-19-related funding and are tracking expenditures from federal funding for approved purposes.

3. Document all communications with regulators regarding use of federal funding related to COVID-19 and business operations during COVID-19, including any transactions-related communications.
4. Assess compliance programs of target companies for effectiveness and identify new risk areas.
5. Continue ongoing compliance activities of portfolio companies.
6. Consider the means and extent of the private equity firm's involvement in a portfolio company's business in general and its government-related business, including establishing clear separation between the private equity firm's operations and the operations of the portfolio company.
7. Revisit business objectives, such as enhancing referrals and increasing revenue, and ensure they are compliant with relevant laws.
8. Confirm any incentives offered comport with anti-kickback and other applicable laws.
9. Understand and comply with all federal, state, and local orders applicable to the relevant portfolio business on an ongoing basis.

As regulators and the public demand more transparency in use of federal funding during the COVID-19 pandemic and general oversight efforts expands, private equity firms should mitigate compliance risks through extensive due diligence, strong compliance management, and training. Proactive steps will reduce the risk of facing a government inquiry and allow for a more robust response to any government action.

ANNEX A

General Legal Diligence Considerations Regarding the Impact of/Response to the COVID-19 Pandemic

Legal topics relevant to assessing the impact of COVID-19 on the target's business in its response to the COVID-19 pandemic include:

- The extent of COVID-19 exposure and transmission at the target's facilities and among the target's employees.
- Changes in state and local laws, regulations, requirements or guidance applicable to the target's operations.
- Compliance by the target and third party with contractual commitments.
- Policies and procedures associated with identifying any patients with COVID-19 symptoms and caring for such patients.
- Protocol changes at facilities where medical services are provided or employees perform services.
- Any changes in hours of operation due to COVID-19.
- Any building rules or policies adopted by a landlord as a result of COVID-19.
- Planning and policies regarding personal protective equipment (PPE) needs in light of the COVID-19 pandemic, as well as the adequacy of a supply chain.
- Reliance on any CMS waivers in connection with the operation of its business as a result of COVID-19.
- Communications to employees and patients.
- Changes to the workforce as a result of COVID-19, including furloughs, compensation reductions or deferrals, reduction of hours, workforce reductions and voluntary departures or leaves of absence, and compliance with related applicable laws (*e.g.*, Worker Adjustment and Retraining Notification (WARN) Act,, Fair Labor Standards Act (FLSA)).
- Compliance with pre-existing labor and employment laws (*e.g.*, Occupational Safety and Health Administration (OSHA), Americans with Disabilities Act (ADA)) as they pertain to COVID-19 in the workplace.
- Compliance with COVID-19 related mandates and guidelines, including FFCRA requirements and CDC guidelines.
- Compliance infrastructure related to the use of any COVID-19-related relief funds.
- Employee/HR policies adopted in response to COVID-19 pandemic, including in relation to remote/work-from-home arrangements.
- Analysis of Health Insurance Portability and Accountability Act (HIPAA) privacy and security in light of remote work changes.
- Changes in employee benefits or benefit plans, including suspension of "required minimum distributions" for 2020 under the CARES Act.
- Cost reduction measures such as reduced capital expenditures or marketing spend.
- Any requests for rent concessions or relief or extended payment terms from vendors.

ANNEX B

Diligence Considerations Regarding Paycheck Protection Program Loans

Where an acquisition target has obtained a PPP loan, the buyer's diligence should include a review of the following:

Target's PPP eligibility:

- The basis of the target's determination that it was eligible for a PPP loan (*e.g.*, the target's primary NAICS code, the total number of employees of the target).
- If the target relied on the number of employees in determining its eligibility, the methodology used in calculating the number of employees.
- The capitalization and ownership structure of the target, and allocation of voting rights among the target's owners and other security holders as of the date of its PPP loan application, as well as any changes in capitalization, ownership or voting rights at any time since January 1, 2020.
- Any other businesses in which any of the target's owners, directors or officers, or any of their immediate family members, hold meaningful ownership positions, board seats, officer positions or other management rights.
- Any management services agreements or similar affiliation agreements to which the target was a party at any time since January 1, 2020.
- The status of the target's sale process, including the existence of any letter of intent, as of the date of the target's PPP loan application.
- Any affiliation analysis conducted by the target in connection with its PPP application.
- Any analysis conducted by the target regarding the necessity of the PPP loan to support the target's ongoing operations, including any consideration of the impact on the necessity analysis of the target's potential impending sale.
- A copy of all board minutes related to the target's PPP loan, including any discussion as to the necessity of the PPP loan to support the target's ongoing operations.
- Any other factors considered by the target in evaluating its eligibility to obtain a PPP loan.
- Whether the target submitted loan applications to more than one lender.
- A copy of any written communications with a prospective lender regarding the target's eligibility to obtain a PPP loan and an explanation of any concerns about the target's eligibility raised by any prospective lender.
- Documentation and calculations supporting the target's calculation of its maximum PPP loan amount.

Accuracy of target's PPP loan application:

- A copy of the PPP loan application as submitted.
- An explanation of the process undertaken by the target to confirm the accuracy of the certifications made in the loan application.

Target's use of PPP loan proceeds and related documentation and recordkeeping:

- Confirmation of the date that the target received PPP loan proceeds.

- A description of the methods used by the target to track the use of the PPP proceeds, including whether the PPP loan proceeds have been held in a segregated account, and all documentation related to the segregation, disbursement or another tracking of such funds.
- Which "covered period" the target has elected to use (*i.e.*, eight weeks or 24 weeks, and whether it intends to use an "alternative payroll covered period").
- Copies of all documentation supporting the claimed forgiveness amount (including, *e.g.*, pay stubs, invoices, payment receipts, vendor agreements, lease agreements, mortgage documents), including a breakdown of the amount spent on "payroll costs" by the employee.
- Copies of 2019 personal tax returns for each owner receiving compensation for services from the PPP loan proceeds.

Accuracy of target's PPP forgiveness application:

- A copy of the application as submitted, together with all related worksheets.
- An explanation of the process undertaken by the target to calculate the claimed forgiveness amount.
- An explanation of the process undertaken by the target to confirm the accuracy of the certifications made in the loan application.
- Weekly employee census reports showing the total number of hours paid to each employee during the following periods:
    a. Each week of the target's chosen reference period for purposes of the FTE Reduction.
    b. Each week since and including the pay period that included February 15, 2020.
- A schedule of all employees who have experienced any decrease in annual salary or hourly wage rate at any time since January 1, 2020.

ABOUT US

The Healthcare Private Equity Team at Bass, Berry & Sims offers an unmatched combination of sophistication and value. We are focused on serving and adding value in the middle- and lower-middle market, and are uniquely positioned to provide the cost-effective yet sophisticated transactional solutions the current environment demands. Our results-oriented, business-minded deal attorneys work seamlessly with our nationally ranked healthcare regulatory attorneys to help private equity clients and their portfolio companies achieve their strategic goals. We represent private equity funds in acquisition financings as borrowers and in mezzanine financing as lenders. Most notably, we pride ourselves as being deal facilitators and real-world risk analyzers. As a result of this experience and depth, the firm continues to be recognized as a staple law firm for private equity funds investing in healthcare. To learn more about our team, industry experience and value-add, click here.

American Health Law Association	Modern Healthcare	Top Ranked Chambers USA 2020	The M&A Advisor	Law360 Group of the Year Health
Ranked 3rd Largest Healthcare Firm in U.S. 2020	Ranked 4th Largest Healthcare Firm in U.S. 2020	Nationally Ranked Healthcare Practice 2020	Healthcare & Life Sciences Deal of the Year ($100MM-$1B) 2019	Law360 Healthcare Practice Group of the Year 2016

> “Deep bench with varied expertise across both regulatory and transactional healthcare matters. Well equipped to handle significant multistate M&A deals, recapitalizations and dispositions. Regularly mandated on joint ventures and syndications, in addition to compliance matters and government investigations. One client notes:
> **'They are consistent and very effective. They also work well with our team and are customer service-oriented.'**”

- Chambers USA 2020

JOIN THE CONVERSATION

Our healthcare private equity attorneys are leaders in industry organizations and are frequently recognized for their significant client contributions and accomplishments. We regularly host reoccurring thought leadership conferences and webinars and author updates on timely topics and developments.

For a list of upcoming events and updates, follow along at bassberry.com/HealthcarePE or connect with us on social media.

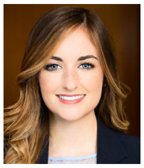
@BassBerryHealth | Bass, Berry & Sims | @BassBerrySims

DEALMAKERS GUIDEBOOK CONTRIBUTORS

Angela Humphreys
Chair, Healthcare Practice Group
Co-chair, Healthcare Private Equity Team
(615) 742-7852
ahumphreys@bassberry.com

Taylor J. Ashley
Healthcare M&A
(615) 742-7860
tashley@bassberry.com

Meredith Edwards Collins
Healthcare M&A
(615) 742-7833
meredith.collins@bassberry.com



Ali Gallagher
Healthcare M&A
(615) 742-7837
ali.gallagher@bassberry.com

John E. Kelly
Government Investigations
(202) 827-2953
jkelly@bassberry.com

R. Davis Mello
Healthcare M&A
(615) 742-6551
dmello@bassberry.com

Ryan D. Thomas
Chair, Private Equity Team
Co-chair, Healthcare Private Equity Team
(615) 742-7765
rthomas@bassberry.com

Bryan W. Metcalf
Tax
(615) 742-6212
bmetcalf@bassberry.com

Frank M. Pellegrino
Healthcare M&A
(615) 742-7947
fpellegrino@bassberry.com

Brian L. Sims
Healthcare M&A
(615) 742-7943
bsims@bassberry.com

Danielle M. Sloane
Healthcare Regulatory
(615) 742-7763
dsloane@bassberry.com

Julia Tamulis
Healthcare Regulatory
Government Investigations
(202) 827-2999
jtamulis@bassberry.com

If you would like more insights on current deal terms or to receive a COVID-19 diligence checklist tailored for your deal, please contact any of the authors or your relationship attorney at the firm.