NEW JERSEY LAWYER

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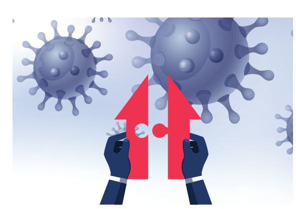

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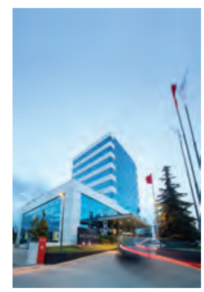

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DOMENICK CARMAGNOLA

Law Center Reopening Symbolic of Crafting the Best Path Forward

My fellow attorneys—I am excited to share with you that, at long last, we will once again be throwing open the doors of the New Jersey Law Center to the legal community.

I will not say welcome back, as doing so suggests nothing has been happening. Indeed, nothing could be further from the truth. Throughout these last 16 months, the New Jersey State Bar Association has taken an all-hands-on-deck approach to getting attorneys and the entire profession the information, resources, assistance, and community they have needed. Today, we remain ever-committed to helping the New Jersey legal community successfully transition from the pandemic-induced shutdown and advance the lessons we learned.

The reopening of the Law Center marks a significant step as our profession emerges from the pandemic and its economic fallout.

Just a few days ago, the Association took part in a listening session about the future of court operations with leading officials in the Administrative Office of the Court. We shared the insights and experiences of our members to help craft the best path ahead. We are thinking critically about what adjustments in the practice of law should be memorialized, where additional potential changes can be made to ensure the entire legal system is in step with advancements in technology and society, and where it is absolutely necessary to return to in-person proceedings to advance the cause of justice for all who come in contact with the system and how that should be done.

The reopening of the Law Center marks a significant step as our profession emerges from the pandemic and its economic fallout.

As we prepare for the next chapter, fully cognizant that things may once again require us to change course, I am optimistic about the days ahead. And I am looking forward to the opportunities we will have to reconnect at the Law Center—our home, and the heart of the state's legal community. On July 16, our Board of Trustees met in person at the Law Center, and the difference from our virtual meetings was palpable in the vibrancy of the discussion, the exchange of ideas and the energy we shared throughout the room.

On Aug. 5, we are holding a job fair. It's our first significant in-person event since the shutdown almost a year and a half ago. It will include New Jersey law firms, attorney employers, and job candidates from a variety of practice areas and experience levels. We are thrilled to contribute to the return of New Jersey's professional legal events with this dynamic offering. Once again, we will gather in person and continue to rebuild from the public health crisis that challenged so many of us in our personal and professional lives.

We will soon announce a full schedule of events, meetings and seminars at the Law Center. These are opportunities to make important and worthwhile business and social connections and to gain access to and the ability to learn from the best legal minds in the state. We are also investing in technology upgrades that will make hybrid meetings more interactive as we are adapting the way we work to serve the needs of our members in every corner of the state. And we are developing the policies and procedures to keep our visitors well informed and safe.

The Association is here for each of you. It is our core mission to help you fulfill your professional and personal goals and serve as a unifying force in the legal community. So rather than say welcome back, I cannot wait to see you so I can say welcome. Until then, stay well and safe. ⚖

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FROM THE SPECIAL EDITOR

Examining the Strategies and Changing Landscape of Venture Capital and Private Equity

This issue of *New Jersey Lawyer* is devoted to venture capital and private equity. The first few articles discuss topics relating to venture capital, and they are followed by articles that address issues with respect to private equity investments.

Anthony Wilkinson opens the issue with a discussion about convertible notes and SAFEs (an acronym for "simple agreement for future equity"). These instruments are used to document the provision of capital that high-growth startups need before funding is provided by venture capital and institutional investors.

Next, Steven Cohen, Benjamin Novak and Evan McGillin summarize the changes to the model legal documents published by the National Venture Capital Association. The model legal documents are widely used in the venture capital and angel investment communities, and the changes reflect the evolving norms in the venture capital industry.

Then, Onome Adejemilua discusses the challenges faced by diverse and women entrepreneurs in the venture capital environment, with a particular emphasis on the obstacles in accessing capital. She also addresses how New Jersey is playing an active role in improving access to capital and closing the funding gap.

Turning to private equity, Jason Navarino and Christine Restrepo discuss the two categories of buyers that purchase private businesses: strategic buyers and financial buyers. They explore the various aspects of a sale to private equity that stand out in contrast to a strategic deal, and they discuss how the COVID-19 pandemic has changed the way these deals progress.

In their article, Michael Zussman and Jacob Shulman analyze COVID-19's effects on pre-M&A operations, the due diligence process, and changes to purchase agreement provisions from the perspective of a seller of a middle-market target company. These changes include how purchase agreements should address PPP loans, furloughed and terminated employees, remote employees, representations and warranties, indemnification obligations and escrows.

SENWAN AKHTAR *is counsel in the Woodbridge office of Greenbaum, Rowe, Smith & Davis LLP, where she is a member of the corporate and real estate departments. She is a member of the editorial board of* New Jersey Lawyer, *and she is the co-chair of the real estate committee of the Middlesex County Bar Association. She serves as outside general counsel for middle-market businesses and represents clients on mergers and acquisitions, joint ventures, and general corporate matters. She also handles the sale, acquisition, leasing and financing of commercial properties.*

Raymond Felton's article focuses exclusively on the topic of earnouts, which are used to bridge the difference between what a seller and buyer believe is a fair and agreeable price for a business. He reviews various issues to consider when negotiating earnouts, and he notes that they can be complicated mechanisms which should be meticulously documented to avoid ambiguity.

Grace Mack and Michael Schaff conclude this issue with their article on issues relating to private equity investment in health care. They provide a guide to the legal and practical issues for a health care entity to consider when reviewing potential private equity investment transactions.

I would like to thank all of the authors for their contributions to this issue of *New Jersey Lawyer* magazine. I would also like to express my gratitude to Mary DeMarco for her invaluable assistance with this issue of the magazine. ⚖

PRACTICE TIPS

WORKING WELL

Be a Good Adversary

By Jeralyn L. Lawrence
Lawrence Law

What does it mean to be a good adversary? To me, it means the following:

- If you are asked for an adjournment—absent extreme, exigent, exceptional circumstances, consent. Do not leave it to your client's discretion.
- Work together to make sure both sides are paid counsel fees.
- Do not engage in letter-writing campaigns.
- Picking up the phone or meeting face-to-face should be a priority in how we communicate with each other. One phone call often disposes of weeks and weeks of letters. Communicating directly often leads to more meaningful and productive conversation. It is also much more difficult to take an unreasonable position when speaking directly.
- If you have a problem connecting on the phone with your adversary, schedule a conference call.
- Don't confuse electronic communication with instant messaging. Many are of the mindset that if they send an email, a response will appear instantaneously. Be more mindful and respectful of how many emails you send. Put all of your thoughts, questions and concerns into one concise email, and send it with all of the formalities of a professional letter.
- Lose the gladiator, win-at-all-costs mentality. Do not make demands; make requests and suggestions. Have goals and objectives instead of problems and disputes, Be respectful.
- Be an advocate—a zealous one—but advocate differently. You can still be strong and clear; just be professional, kind, and courteous at the same time.
- Do not object if your adversary files a motion to get out of the case.
- If you serve a motion, send two copies. If you have exhibits, use exhibits tabs. Not only do the Court Rules require it, but it is also the courteous thing to do.
- Do not sit at the head of the table in a meeting. Progress suffers when we engage in power struggles. Be a decent example to your clients, and show that if you can cooperate, so can they.
- Change your letters to change your approach. Rather than write *Jones v. Jones* in the "Regarding" line, I write "In the Marriage of Jones," which reads more respectful to the parties. Be cognizant of your client's feelings and remember that things you deem inconsequential could have great significance to them.
- Remember that all we ever needed to know about life and the successful practice of law, we learned in kindergarten. Be nice. Build relationships. Your reputation is everything and is always on the line. Be credible. Be reliable. Be on time. Have lunch with friends and colleagues. And face-to-face contact is invaluable.

TECHNOLOGY

Why You Need a Password Manager

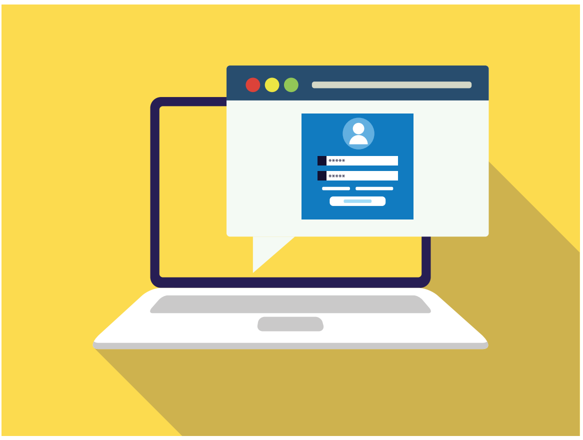
By Jeffrey R. Schoenberger
Affinity Consulting

A password manager is a program that helps one store, create and organize passwords (and logons and websites, etc.). The purpose of a password manager is three-fold:

1. The program helps you create and store the innumerable login credentials that we all generate. A password manager can propose super-complex, impossible-to-guess, and impossible-to-remember, unique passwords for each site requiring a login. Most password managers also offer to store ancillary data, like software license keys, credit card numbers, store rewards card numbers, and things of that nature.
2. The password manager installs a plugin in your browser and "watches" while you surf the web. If you visit a site for which

you've already created or stored credentials in the password manager, it offers to log you in without you having to type, or even copy and paste, your credentials. If you visit a site for which you need to create a username and password, the password manager suggests strong passwords.

3. Most, but not all, password managers let you sync your data over the internet. That way, those super-strong, unmemorizable passwords are accessible on your smartphone, tablet, and any additional computers you have. Having those passwords



stored with a third party understandably makes some folks nervous. But, unlike most cloud storage vendors, you define the password that unlocks your data. If the password syncing website suffers a breach, the hackers can steal only encrypted data. They still need your "master password" to decrypt your password file. That master password is the one unique, complex password that you do need to memorize.

Benefits of Password Managers

1. It's a place to keep logons, websites, account numbers and passwords all in one place. I use 1Password and it will generate and store strong passwords for me (so I don't have to make them up).
2. It will also let me know if my passwords are weak and recommend that I change them. It tells me how many different websites I'm using the same password for (it's not recommended that you use the same password for everything).
3. It also lets me know if there are any reported security breaches for any of the websites it holds passwords for and recommend that you change them.
4. It will hold all my credit card information, secure notes about anything I want and personal information like my driver's license, passport, etc.
5. Finally, it's part of my estate plan. If something happens to me, there's one place that other family members can go to find all pertinent information; everything from credentials to where to pay the water bill, to PDFs of my actual estate plan documents. In 1Password, this feature is called the Emergency Kit, which is a fancy name for a mix of computer and handwritten information that you complete and store somewhere secure, like a safety deposit box, that family members can access if needed. It will have confidential access information, so it's not something to keep out in the open.

Good Options

Top-rated password managers include the following (and I strongly recommend the versions you have to pay for—almost all offer a free version that is missing features):

1PASSWORD: 1password.com
DASHLANE: dashlane.com
LASTPASS: lastpass.com
LOGMEONCE: logmeonce.com
KEEPER DESKTOP: keepersecurity.com
ROBOFORM: roboform.com
STICKY PASSWORD: stickypassword.com
TRUEKEY: truekey.com

PRACTICE PERFECT

Recruitment and Retention

By Aparna Tutak
Affinity Consulting

When it comes to business development for their law firms, most lawyers consider client acquisition the single most important barrier to their profitability and long-term success. But true business development requires more than growth in the number of clients a firm has. A growth-minded law firm cannot be successful without considering the role that recruitment and retention play in keeping a firm's most important assets—its employees—thriving in a post-pandemic workplace. Like it or not, the world has changed, and in an industry typically slow to adopt change, many firms have struggled to accept new mindsets as the nature of how work gets done has shifted in a short amount of time. Law firm management now means that remote working will remain prevalent, but other than requiring employees take laptops home, how should firms

approach "top-down" business development? Hint: it requires more than the help of the law firm's IT department.

You may be asking, "My law firm is amazing, and anyone should be lucky to be hired to work here so why should I worry about recruitment"? Simply put, employees are demanding more of their employers to account for the shift in remote working. According to a recent survey by Robert Half, 34% of work-from-home employees would rather quit their jobs than return to the office full time. Working from home (or anywhere outside the office) means that employees must prove with twice as much certainty that they're worth the investment in hiring them and that they're performing well at the job they were hired to do. Employers need technically-savvy attorneys and staff who can pivot easily from working in an office to working remotely and back without sacrificing the amount or quality of work that gets done. What are the types of changes prospective employees and employers should expect in the brave new, post-COVID world?

Getting To Know You, Digitally

Diminished travel to law school campuses for candidate interviews means that recruiters will be conducting interviews via Zoom. This saves firm members time and money on resources spent on travel but also eliminates the opportunity for spontaneity that comes from in-personal interactions. Firm members and candidates should not presume that a Zoom interview is any less formal than an in-person meeting. Savvy candidates will dress professionally and be mindful of what's in the background during their on-camera interview (think of investing in a ring light to optimize your video presence). After all, this is a testimonial of the professionalism a candidate will be expected to have when working with a paying client and while it may be unfair, a poor work environment with dirty towels on display in the background, make for a sloppy impression to those who surround you, even virtually. Firms are also utilizing behavior assessments like DISC Assessments to help evaluate how candidates interact with their peers and leadership. In lieu of lengthy, in-person interviews, such assessments provide a look into the patterns and mindsets of prospective and existing employees.

The social media presence of prospective candidates will be more carefully scrutinized. Candidates actively participating in legal community forums or those consistently creating, curating, and sharing content are telling recruiters that their expertise is valuable, as is their potential reach for fostering potential client relationships if hired. Firms that no longer see clients in physical offices need staff with the ability to cultivate relationships with prospective clients in digital spaces. Tomorrow's law firms will need to embrace this digital shift, or risk losing talent and ultimately revenue to savvy competitors who will.

Embrace The Hybrid Workplace

The shift to remote working means that, while some people feel comfortable and miss the comradery of being physically present in an office, others have found their stride in working from home, or cannot return to the office due to health concerns, having to care for ailing family members or lacking child care. Employers unwilling or unable to accommodate the shifting needs of employees risk a mass exodus of talent as many other employers have already realized the evolving needs of legal professionals and are jumping at the chance to acquire new talent. In many cases, being tethered to a desk is no longer an option and more importantly, it's just not necessary.

Attorneys have found that they love the flexibility remote work affords and the elimination of time lost commuting to the office. Retaining employees is more than a matter of paying someone more. Workplaces need to capitalize on the efficiency gained from remote workers rather than see them as a hinderance to returning to "normal." This requires a shift in more than just the firm's culture. It requires a commitment to "cut the cord" with on-premise technology solutions and the adoption of a cloud infrastructure to run the practice.

People want to do their jobs well and it's up to employers to make it easier for their employees to succeed. Successful firms that are focused on long-term business continuity are simultaneously capitalizing on cloud applications and enacting change in their firms to better position themselves from future crises. This driver has led to firms adopting cloud-based solutions for team collaboration, productivity enhancements and streamlined communication via Microsoft Teams or NetDocuments, a true cloud document management solution.

A lack of technology investment shows prospective new hires that the firm does not care to innovate and improve, which could scare top-performers away. Candidates want to work at firms that can compete with AmLaw 100 firms regardless of size. Maintaining an on-premise environment that doesn't allow the flexibility to get work done in an efficient manner is enough to scare off people otherwise ideally-suited for a position. Employees may wonder, "If the firm doesn't think it's worth investing in itself as a company, why would they invest in me as an employee." This demoralizing narrative is all too common in workplaces today and sets the precedent that a team member's value is limited and static rather than encouraged to improve. Firms that innovate and reimagine their business practices foster that type of creativity and drive in their employees. ⚖

Convertible Note and SAFE Financing for High-Growth Startups

By Anthony E. Wilkinson

ANTHONY E. WILKINSON *is a Yale Law grad and the principal of Wilkinson Law LLC, a small firm in Old Bridge. The firm focuses on acquisitions of privately-held companies and financing for high growth start-ups.*

Infancy is the period of the greatest and most rapid development and growth for human beings. Survival during this critical stage comes by intaking large quantities of special nutrients in a manner that is particularly suited to those who are so young. Likewise, convertible notes and SAFEs are the legal instruments which provide the vital nutrients, in the form of cash rather than milk, that high-growth startups need during that critical period between when their funding comes from founders, family and friends and when it is provided by venture capital and institutional investors. A convertible note is an unsecured short-term debt instrument issued by the company where the debt may convert into stock under certain conditions.[1] A SAFE is an instrument for which the holder pays cash to the company for the right to receive company stock under certain conditions.[2] SAFE is an acronym for "simple agreement for future equity." This article is a primer on these two important sources of financing.

Debt

A SAFE instrument is generally not considered to be debt.[3] It does not have a maturity date, an interest rate or a term. Indeed, there is no obligation of the company to ever repay the cash paid by the SAFE holder.

Convertible notes are debt instruments. Like any promissory note, convertible notes set forth a term, an interest rate and a maturity date. On the maturity date, the full amount of the debt, along with any other financial obligations arising under the note, must be paid. The term of the note is the time from the date the loan is made to the maturity date, usually from 12 to 24 months. The length of the term is based on the company's expectation that it will receive additional financing from venture capital firms or institutions before the term ends.

A convertible note usually specifies multiple triggers for repayment of the debt. Of course, it must be repaid on the maturity date. There are also other events which may require repayment such as an initial public offering, a merger or acquisition, a change of control or a liquidation and dissolution. In some cases, a note may require the payment of a multiple of the principal of the loan plus interest.[4]

Unfortunately, it is not unusual for a start-up to have insufficient cash to repay the note if it ever becomes due. Since the note is not secured, the note holder cannot foreclose on the assets of the company. In such cases, the note holder may choose to renegotiate the terms of the loan. For example, the maturity date may be extended, the interest rate may be increased or the debt may immediately convert into some type of new or existing stock of the company.

Conversion

The typical situation under which a company issues a SAFE or convertible note is when the company is a C corporation in growth mode. For simplicity, we will also assume that the company has not issued any stock options and does not have an equity incentive plan for its workers. Our discussion will also only focus on instruments that have a single investor rather than multiple investors under the same instrument or related instruments.

The desired outcome for a holder of a SAFE or convertible note is for its capital contribution to be converted into preferred stock issued by the company when venture capitalists or institutions invest in the company during the first round of investing where there is a fixed valuation for the company. This stock issued in this round is usually called "Series A Preferred Stock." We will refer to this type of financing round as a "Priced Round."

A difference between SAFEs and convertible notes is that SAFEs usually do not require a minimum investment by the institutions or venture capital firms to trigger conversion, but convertible notes do. A financing that satisfies the minimum investment condition for conversion under a convertible note is called a "Qualified Equity Financing." A financing that satisfies the investment condition for conversion under a SAFE is called an "Equity Financing." For simplicity, we may use the term "QEF" to refer to a financing that triggers conversion whether we are discussing convertible notes or SAFEs.

In addition to QEFs, there are other situations which could trigger a conversion to stock under a convertible note or SAFE such as an initial public offering, a merger or sale of the company, a change of control or, for convertible notes, the occurrence of the maturity date.

Another important point to consider is the type of stock issued upon conversion. Of course, in a Priced Round, when the venture capital and institutional investors receive preferred stock, the holders of convertible notes and SAFEs will receive the same class of preferred stock. In other situations, there may be no associated issuance of preferred stock, such as in an initial public offering or a merger or sale of the company. In these instances, there would typically be a conversion into common stock. For a conversion on the maturity date of a convertible note, the type of stock could be specified as common stock or perhaps a new series of preferred stock.

Valuation

The difficulty of valuing a company in its infancy is the reason why investors seek to use convertible notes and SAFEs. Ideally, at any point after the formation of the company, the founders could engage consultants or financial advisers to value the firm. However, the cost of doing so is often prohibitive for a start-up company. Another problem is that any such valuation may be unreliable if mission critical technology is not well developed.

Let's look at an example to understand the problem solved by convertible notes and SAFEs.

Suppose A is an angel investor who wanted to invest $100,000 into ABC Corp. If the value of the company was $1 million, then A would receive a 10% interest for its $100,000. But if the value of the company was $10 million, then A would receive only a 1% interest for its $100,000. So the question is "Should A receive a 10% interest or a 1% interest?" That's a big difference. The parties are not really certain about the value of the company, so it would not make sense for them to waste time and money haggling over specific terms. The solution to this problem is for A to invest in the company through the vehicle of a convertible note or a SAFE. Then, upon a Priced Round, the extent of A's ownership interest will be determined based upon the value of the company agreed upon by the company and the venture capital or institutional investors.

There are many significant provisions to understand in a convertible note or SAFE. These include discounts, valuation caps, most favored nation clauses, information rights, participation rights, major investor rights, and board observation rights. It is atypical for holders of convertible notes or SAFEs to receive board membership rights or protective provisions to restrict certain actions of the company.

Out of all of these terms, the two most important are discounts and valuation caps.

Discount

Let's first examine the concept of a discount in a convertible note or SAFE. Again, the best way to understand it is through the use of an example.

As we previously stated, in a Priced Round, the company and the investors have agreed upon a value of the company. We are going to assume the value is $10 million and that this is a pre-money valuation, meaning that it is the value of the company before the investors' money is transferred to the company's account. We will also assume that there were 10,000,000 shares of common stock issued and outstanding before the QEF, and the investors have agreed to pay $1.00 per share of preferred stock. Given our assumptions, the term "Fully Diluted Capitalization" will mean 10,000,000 shares. For clarity about the sequence of equity issuances, we are going to assume that the Priced Round investors receive their preferred stock first, and then the convertible note or SAFE converts into preferred stock.

Now that we have established our assumptions, let's examine a situation where there is no discount. This case is simple. The note or SAFE holder invested $100,000. The price per share for preferred stock is $1 per share. Therefore, the convertible note or SAFE will convert into 100,000 shares of preferred stock.

Now let's consider the case where the convertible note or SAFE states that there is a discount equal to 20%. We will see that this benefits the note or SAFE holder because the conversion will occur at a lower price per share; the price per share of preferred stock will be reduced by the discount percentage. Thus, if the price per share of preferred stock is $1.00, then that price discounted by 20% is $0.80. That is the price at which the note or SAFE will convert even though the venture capital and institutional investors will still pay the full price of $1.00 for each of their shares of preferred stock.

The discounted share price for the note or SAFE holder means they will receive more shares. If the note or SAFE holder invested $100,000, then that amount will convert to 125,000 shares at $0.80 per share. So instead of receiving 100,000 shares, the note or SAFE holder receives 125,000 shares, an additional 25,000 shares due to the discount.

Note and SAFE holders negotiate to obtain significant discounts because they take the risk of investing in the company before the value of the company is known with certainty. As a reward, they become entitled to a discounted price relative to the price paid by the investors in the Priced Round.

Cap

Another important concept for convertible notes and SAFEs is the valuation cap. Let's consider an example. First, let's recall the situation where there was no discount stated in the instrument. In that instance, there was also no valuation cap. The note or SAFE holder invested $100,000, the instrument converted into preferred stock at $1 per share, and the note or SAFE holder received 100,000 shares of preferred stock.

Suppose the note or SAFE states there is a valuation cap of $4 million. We will see that this benefits the note or SAFE holder because the conversion will occur at a lower price per share; the price per share will equal the valuation cap divided by the Fully Diluted Capitalization. In this case, that would be $4 million divided by 10 million shares resulting in a price per share of $0.40 for the note or SAFE holder even though the Priced Round investors would still pay $1 per share. At $0.40 per share, the note or SAFE holder will receive 250,000 shares for its investment of $100,000. Thus, due to the valuation cap, it receives 250,000 shares instead of 100,000 shares; that is an additional 150,000 shares of stock. That is the reward for the note or SAFE holder investing in the company well before anyone could be sure about how much the company was worth.

Discount and Cap

Sometimes a convertible note or SAFE will have both a discount and a valuation cap. In this case, the note or SAFE holder would be allowed to select the most favorable approach at the time of the Priced Round. In our examples, if there was both a 20% discount and a $4 million valuation cap, then the discount would result in a conversion into 125,000 shares at $0.80 cents per share, and the valuation cap would result in a conversion into 250,000 shares at $0.40 cents per share. The valuation cap is more advantageous, and it would be selected as the desired method for conversion.

Types of SAFEs

There are many different types of SAFEs with their own advantages and disadvantages. Some of the most popular ones are issued by Y Combinator and Gust.[5] 500 Startups issues a form instrument similar to a SAFE called a "KISS," an acronym for Keep It Simple Security.[6]

It is important to take care when modifying any of these standard forms. Upon receiving one to review, it is important to look for a representation stating that it has not been modified from the standard form; otherwise it would be advisable to perform a comparison to the standard form to determine what changes were made.

Securities Laws

Convertible notes and SAFEs are securities and thus there are securities laws that should be considered. The most important is Rule 506 of Regulation D of the Securities Act of 1933.[7] In most cases, to avoid burdensome, time-consuming and costly regulatory requirements, convertible notes and SAFEs are only issued to accredited investors, as defined under Regulation D[8]. There have been cases where the Securities and Exchange Commission has filed actions for violations of Rule 506.[9] There is also a federal requirement to file a Form D.[10] In addition to federal laws and regulations, there may be state law applicable based upon the residency of the investor. Even if federal securities laws preempt a particular state securities law, the state may still require notice filings.[11] Due to the applicable securities laws, there are restrictions on the transfer of convertible notes and SAFEs which should be stated prominently in the instrument.[12]

Stacking

Founders should be careful not to succumb to the unwise practice of "stacking." Initially, the company may offer convertible notes or SAFEs with low valuation caps or high discounts to incentivize the early investors. Then, as the company gains success in raising capital, it offers convertible notes or SAFES with higher valuation caps or lower discounts. Thus, the founders are later "stacking" convertible notes and SAFEs on top of earlier ones that have different terms. This is a situation that venture capital and institutional investors would prefer to avoid. The company may need to incur a significant legal expense to rectify the problem.

Another danger of stacking is that the founders may not be inclined to engage in the complex computations and administrative hassle of managing multiple instruments with different terms. Consequently, they may not understand the significant dilutive effect the conversion of these instruments will have on their equity interest during the Priced Round. They may wind up owning far less of the company than they thought they would.

Thus, it is best to use either convertible notes or SAFEs, but not both. And then, for whichever instrument is chosen, the recommended course is to have terms that are consistent for all investors.

Conclusion

Convertible notes and SAFEs are designed for those high growth private companies that are developing into an enterprise that will attract venture capital or institutional financing. Fortunately, there are investors who are willing to undertake the substantial risks at this early stage. Instead of wasting time and money haggling over the value of the company, these investors focus on reaching agreement about the type of financing instrument and whether it will include a discount, a valuation cap or both. Then, in short order, the rest of the terms are resolved, the documents signed and cash, that essential nutrient needed by these young and active companies, starts to flow. They are on their way toward becoming the mature and flourishing companies that change our world every day. ⚖

Endnotes

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2. For an example of a SAFE, see ycombinator.com/documents (accessed February 22, 2021).
3. Neither the Federal Accounting Standards Board nor the SEC nor the IRS has made a definitive statement regarding the treatment of SAFEs as debt. However, the SEC has come close by defining a convertible note as debt and then stating that SAFEs are different: "Different from SAFEs, convertible notes generally represent a current legal obligation by the company to you for the outstanding amount of the note." sec.gov/oiea/investor-alerts-and-bulletins/ib_safes (accessed February 25, 2021).
4. In some states, the repayment of a multiple of the principal may raise an issue of whether such an arrangement violates laws against usury. As of February 22, 2021, the New York Court of Appeals has not decided a question certified by the Second Circuit of the Federal Court of Appeals regarding whether laws against usury in the State of New York were violated when debt was converted into stock pursuant to a convertible note. See *Adar Bays, LLC v. GeneSYS ID, Inc.*, No. 18-3023 (2d Cir. 2020).
5. *See* ycombinator.com; gust.com (accessed February 27, 2021).
6. *See* 500.co (accessed February 27, 2021).
7. 17 CFR § 230.506
8. 17 CFR 230.501(a)
9. *See*, e.g., *SEC v. Schooler*, 106 F. Supp. 3d 1157 (Dist. Court, SD California 2015)
10. *See* 17 CFR § 239.500; sec.gov/about/forms/formd.pdf (accessed February 27, 2021).
11. *See* N.J.A.C. 13:47A-7.10(a).
12. *See* 17 CFR § 230.502(d)(3).

Evolving Market Terms for Venture Capital Investments

Trade Association Updates Standards

By Steven M. Cohen, Benjamin David Novak and Evan J. McGillin

On July 28, 2020, the National Venture Capital Association, the trade association for the venture capital community in the United States, published much-anticipated updates to its model legal documents, which are available for free download on the NVCA's website. These documents are widely used in the venture capital and angel investment communities and have become the industry standard for use by lawyers representing emerging growth companies and investors to effectively and efficiently document the terms of equity financings. This article summarizes the updates to the primary model legal documents, which include a Term Sheet, Certificate of Incorporation, Stock Purchase Agreement, Investors' Rights Agreement, Voting Agreement, and Right of First Refusal and Co-Sale Agreement. The NVCA model documents assume the company is organized as a corporation, although they are adaptable for other applications.

Term Sheet

The Term Sheet facilitates the discussion and agreement upon the key business and legal terms of the investment between the company raising capital and the lead investor for the round. While negotiating the Term Sheet, the company and the investor are able to focus on the primary economic and control issues involved in the proposed investment, facilitating a quick and cost-effective determination whether there is business agreement on the proposed terms. The Term Sheet, among other things, sets forth the type of securities being purchased by the investor, the price per share (and the corresponding pre-money valuation of the company), and the control and economic rights and preferences of the securities being purchased (including dividend rights, rights upon liquidation, redemption rights, etc.). The NVCA Model Term Sheet was updated as follows:

- ***Anti-Dilution***. While prior iterations of the Term Sheet included multiple alternative anti-dilution adjustments—a mechanism to adjust the rate at which the shares of preferred stock convert into common stock upon the occurrence of certain events, including to account for the dilutive effect of "down rounds" if the company issues shares at a lower price per share than the price paid by the investor—the Term Sheet now only includes a "broad-based weighted average" anti-dilution formula, which has been by far the most common formula used in venture financings.
- ***Legal Fees***. A section in prior versions of the Term Sheet, with respect to the company's obligation to pay the fees of investor's counsel, is no longer a default binding provision and the obligation to pay the out-of-pocket fees of investor's counsel is subject to the closing of the financing, and most frequently capped in dollar amount, reflecting current market practice.

Certificate of Incorporation

The company's Certificate of Incorporation (Charter) is a publicly filed document that authorizes different classes of capital stock of the company and sets forth the relative rights, preferences, and privileges of such classes of stock. The NVCA Model Charter was updated as follows:

- ***Dividend Language***. The Charter now includes a provision for non-cumulative preferred dividends at a specific rate (customarily 5%-8%) which are paid prior to and in preference to any other dividends. Note, however, that the fixed rate dividends are only payable when, as, and if declared by the Board of Directors and, as a practical matter, venture backed companies rarely declare dividends.
- ***Protective Provisions***. The protective provisions—provisions requiring the company to obtain the consent of holders of a majority (or possibly higher percentage) of the preferred stock prior to taking certain enumerated actions—were updated to: (i) expand the protective provision for the creation, reclassification or increase of authorized shares of a series of capital stock; (ii) include a new protective provision for amendments of equity incentive plans and amendments to the terms of any equity awards granted pursuant to such equity incentive plans; and (iii) expand the protective provision for effecting a change to the authorized number of directors on the Board of Directors to include any changes to the voting power of each director.
- ***Mandatory Conversion on Direct Listing***. The Charter now provides for mandatory conversion of the preferred stock to common stock in the event of a direct listing of the company's common stock on a nationally recognized stock exchange, in addition to upon a Qualified IPO (as defined in the Charter) or upon the consent of holders of a majority (or possibly higher percentage) of the preferred stock.

Stock Purchase Agreement

The Stock Purchase Agreement (SPA) is the document that sets forth the terms and conditions regarding the investor's purchase of shares of the company's preferred stock. The NVCA Model Stock Purchase Agreement was updated as follows:

- ***Removal of Founder Representations and Warranties***. While

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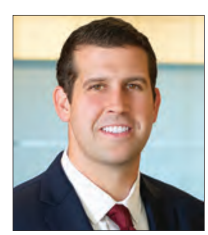

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previous iterations of the model SPA included suggested language for representations and warranties to be made by the founders of the company, these representations and warranties have been removed in the updated SPA, requiring investors to rely upon the representations and warranties made by the company alone.

- ***Representations and Warranties***. The representations and warranties to be made by the company were updated as follows:
  - The open source software representation was revised to narrow the representation and limit it to open source software licenses that would impose significant obligations on the company;
  - The employee census representation, which required disclosure of compensation arrangements with each employee of the company, was deleted;
  - The representation with respect to data privacy has been substantially revised to address updates to data privacy laws; and
  - Two new sample representations have been added where any investors are non-U.S. persons concerning matters related to review of the proposed financing by the Committee on Foreign Investment of the United States, including changes in response to the Foreign Investment Risk Review Modernization Act, which expand the scope of CFIUS review of non-controlling investment in U.S. companies by foreign investors. Section 2.30 of the SPA now includes a representation by the company confirming that it does not currently conduct certain activities that may trigger CFIUS review, and Section 3.9 of the SPA now includes a representation by each investor that it is not a "foreign person" or "foreign entity" as those terms are used in applicable CFIUS related regulations, and that the investor does not permit a "foreign person" to obtain CFIUS triggering rights by virtue of its investment.
- ***Closing Conditions***.
  - The SPA now includes a footnote in the closing condition requiring delivery of a legal opinion by the company's counsel stating that parties may forego delivery of a legal opinion as a result of the expense and time associated with such legal opinion. Prior to these updates, the delivery of a legal opinion was the default position in the document (although in practice delivery of a legal opinion varied financing to financing, with earlier and smaller financings rarely requiring one).
  - The requirement that the company satisfy preemptive rights with respect to the preferred stock issued to the investors has been removed as a closing condition as these rights can often be more efficiently satisfied or waived following the closing of the new investment.
  - ***Notice Provisions***. The SPA was updated to reflect the latest e-notice provisions of Delaware law and to provide permissibility of electronic notices subject to certain requirements and limitations as set forth therein.

Investors' Rights Agreement

The Investors' Rights Agreement is the document pursuant to which the company grants investors (sometimes limited to certain "Major Investors" holding a negotiated minimum amount of stock of the company) certain rights, including information rights, rights to participate in future financings, and registration rights. The NVCA Model IRA was revised as follows:

- ***Treatment of "Competitors"***. The revised IRA notes that the use of the defined term "Competitor" in the document applies only to rights to future stock issuances. Other mentions of "competitors" in the context of transfer restrictions and information rights are not defined, allowing the company more flexibility to determine what constitutes a "competitor" in such instances.
- ***Underwriting Requirements***. Section 2.3 provides sample language that would exempt stockholders from the need to make representations in an underwriting agreement with respect to the registration of the company's securities in a public offering (except with respect to their ownership of shares of the company) and further limits the stockholders' liability with respect thereto.
- ***Lock-Up Restrictions***. The "market stand-off" restrictions in Section 2.11 (commonly referred to as a lock-up provision) have been revised to reflect changes in regulatory framework, including a new exception for the establishment of a 10b5-1 trading plan (a plan that allows certain insiders of the company to sell shares of capital stock in predetermined amounts and at predetermined times to comply with insider trading laws).
- ***Restrictions on Transfer***. Section 2.12 includes new language that would provide that shares transferred pursuant to an effective registration statement or, following an Initial Public Offering, pursuant to Rule 144, would no longer be bound by the terms of the IRA.
- ***Information Rights***. Section 3.1 now requires the company to deliver financial statements after each fiscal quarter of the company, not just the first three fiscal quarters.
- ***Extension of Information Rights for Transactions Involving New Private Company Securities.***

Section 3.4 clarifies that information rights shall continue in any successor company that is not subject to periodic reporting requirements of the Securities Exchange Act of 1934.

- ***Waiver of Statutory Stockholder Rights***. Newly added Section 3.7 provides a sample provision for the waiver of all Delaware statutory rights to information regarding the company under Section 220 of the Delaware General Corporation Law.
- ***Termination of Information Rights and Rights to Future Stock Issuances***. The revised IRA removes prior language that would terminate the investors' information rights and preemptive rights when the company first becomes subject to the periodic reporting requirements of the Securities Exchange Act of 1934, although underwriters in an IPO frequently seek such post-IPO termination of rights.
- ***CFIUS Considerations***. The revised IRA includes multiple changes with respect to CFIUS, including:
    - The right to require the company to register shares provided in Section 2.1(a) has been revised to exclude any stockholder that is a "foreign person" from triggering the demand right;
    - Inclusion of a covenant that the company will not provide an investor that is a "foreign person" with access to any "material nonpublic technical information" as that terms is used in applicable CFIUS related regulations;
    - Inclusion of a limitation on the rights to future stock issuances that no "foreign person" investor shall use the preemptive rights to acquire unsubscribed shares in a future offering to purchase more than 9.9% of the company's voting securities; and
    - Inclusion of a new covenant preventing the company from providing certain rights to "foreign persons" in order to comply with CFIUS.
- ***Company Covenants***. The revised IRA includes drafting clarifications, modifications, and slight expansions to many of the sample company covenants in Section 5. Some noteworthy changes include:
    - Suggested language for extending D&O insurance to investors entitled to designate directors;
    - Suggestion for Preferred Director approval of vesting acceleration provisions with respect to any equity award grants;
    - Significant expansion of the company's obligations to provide a certification to investors that the company is a "Qualified Small Business" and that the shares of preferred stock issued to the investors will be "Qualified Small Business Stock"; and
    - New covenants related to the foreign corrupt practices act, cybersecurity, and real property holding corporations.

Voting Agreement

The Voting Agreement sets forth the agreement and understanding of the stockholders with respect to how shares of capital stock held by them will be voted in connection with the election of the board of directors, a sale of the company, and certain other matters. The NVCA Model Voting Agreement was updated as follows:

- ***Board Composition***. The Voting Agreement has been updated to delete the covenant with respect to maintaining the size of the board, and a footnote was added to highlight that board size may be addressed in the Charter or the bylaws.
- ***Drag Along***. The Voting Agreement adds a condition to the drag-along—a provision that provides that all stockholders must vote their shares in favor of a sale of the company that is approved by the Board of Directors and certain predetermined groups of selling stockholders—that the stockholders are not required to grant releases in connection with such sale of the company other than a customary release of claims arising solely in their capacity as a stockholder.

Right of First Refusal and Co-Sale Agreement

The NVCA Model Right of First Refusal and Co-Sale Agreement, which provides for restrictions on transfer of shares of capital stock held by certain "key holders," such as founders of the company, was revised to update the lock-up provisions to allow establishment by the restricted holders (generally founders and senior company management) of a 10b5-1 trading plan during the lock-up period as long as the plan does not permit transfers of shares during that lock-up period.

Conclusion

The updates to the model legal documents reflect the evolving norms in the venture capital industry and updates to state and federal laws applicable to venture-backed companies in the United States. The updated model legal documents continue to establish a framework for effective and efficient negotiations between startup companies and venture capital investors, establish market terms, and further the NVCA's goal to provide a comprehensive set of internally consistent financing documents to reduce transaction costs and time in negotiating and closing a venture capital or angel investment financing. ⚖

Addressing the Funding Gap for Women and Diverse Entrepreneurs

By Onome Adejemilua

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Historical Landscape for Women and Diverse Entrepreneurs

As key drivers of innovation and productivity, entrepreneurs are fundamental to the prosperity and growth of the U.S. economy. Robust entrepreneurial activity and small business ownership provide the basis for economic prosperity and are critical to the long-term vitality and success of our country.[1]

In recent years, diverse and female business owners have risen as essential players in the U.S. entrepreneurial landscape, accounting for a sizeable portion of the economy and driving job creation. By 2015, diverse-owned companies had grown to approximately 8 million, a 38% jump from 2007, employing more than 8.7 million people and generating roughly $1.4 trillion in annual gross revenues.[2] By 2019, there were more than 13 million businesses owned by women, employing approximately 9.4 million people and generating $1.9 trillion in revenue.[3]

As the face of entrepreneurship grows beyond the traditionally non-diverse, male portrait, the map of entrepreneurship has also expanded beyond the conventional hubs of Silicon Valley and Boston into burgeoning metropolises.[4] New Jersey's largest cities have similarly experienced increased levels of entrepreneurial activity in recent years, with Newark emerging as a prominent destination for entrepreneurs and startups, particularly in the technology industry.[5]

Despite the growing number of female and diverse entrepreneurs, and their influence on the economy as a whole, these businesses face obstacles and barriers to growth, especially as it pertains to funding and investment.[6] While funding sources for these groups are historically scarce, venture capital financing, in particular, critical to providing startups with scale-up capital, has continued to lag.

This article will discuss the challenges faced by diverse and women entrepreneurs in the venture capital ecosystem, with particular emphasis on the gap in accessing capital. It will examine the innovative ways that the industry is tackling the funding gap—ways that are not only designed to produce more equitable results, but generate higher returns for investors. It will also address how New Jersey is playing an active role in collaborating with industry players to improve access to capital and close the funding gap.

Closing the funding gap, however, will ultimately require a commitment to changing the venture capital (VC) culture from being reliant on the subjective, bias-prone pitching process to adopting a more data-driven approach to sourcing, evaluating and selecting investment opportunities.

Obstacles to Capital Access—The Funding Gap

Access to capital is critical to the success of any new business.[7] Businesses that start with strong financials are more likely to succeed, as a strong financial condition allows entrepreneurs to take advantage of expansion opportunities and make critical infrastructure investments.[8] Studies show that young companies supported by accelerators that received financial and nonfinancial assistance in the form of mentorship and technical assistance experienced approximately 30% more revenue growth and approximately 50% more employment growth within two years of raising capital than those that did not raise capital.[9]

Despite the importance of early capitalization to the growth and development of startups, entrepreneurs from underrepresented demographic groups tend to face hurdles in securing base and early-stage capital. Historically, women are less likely to receive funding in early-stage decisions from angel investors and venture capital firms.[10] Based on data from Pitchbook, in 2017, all-women founding teams raised 2.2% of total VC funding (accounting for fewer than 5% of deals) compared with all-men teams that raised about 79%.[11]

The disparity is even more glaring for ethnically-diverse founders. Findings in a study conducted by Diversity VC and RateMyInvestor demonstrated that from 2013 to 2017, of the 4,475 investments made by 135 venture capital firms reviewed in the study, only 1% and 1.8% were led by Black and Latino founders, respectively.[12] These numbers have taken even sharper dives during the COVID pandemic, as, in the face of uncertainty, investors have remained close to their networks and put on hold initiatives promoting diversity and inclusion.[13]

Insular Networks of Venture Capital

A closer examination of the culture within the venture capital industry may provide clues as to why there is such an imbalance in access to capital. The venture capital industry is a notoriously insulated and non-diverse, all-boys club.[14] Women and people of color have historically been underrepresented in the VC ecosystem on both sides of the aisle, as founders and funders.

Research shows that 92% of the partners in the venture capital industry are men and most are non-diverse.[15] Given that most investors rely on referrals from their networks, which tend to be people just like them, female and diverse entrepreneurs are left with uneven access to the social and intellectual capital necessary to secure funding.[16]

Bias in the Pitching Process

Another culprit of the funding gap is the apparent bias in the VC investment process. Multiple academic studies have demonstrated that a strong gender bias exists in many elements of the pitching process.[17] One study established that investors prefer pitches presented by male entrepreneurs compared to pitches made by female entrepreneurs, even when the content of the pitch was exactly the same.[18] There, the participating investors who were asked to rate presentations voiced by men and women, using identical slides and scripts, consistently rated the men higher, with attractive men being evaluated as the most persuasive.[19]

Another study examined how bias factors into the questions that entrepreneurs are asked during the pitching process. The research found that investors tend to pose questions to male entrepreneurs that are of a promotional nature (i.e. highlighting the upside and

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potential gains) while female entrepreneurs received questions of a preventative nature (i.e. highlighting potential losses and risk mitigation).[20] The difference in questioning appeared to have substantial funding consequences for startups with the female entrepreneurs who fielded mostly prevention questions raising roughly seven times less than the entrepreneurs who were asked mostly promotion questions.[21]

Diverse entrepreneurs also tend to be perceived by investors as risky investments.[22] In a survey conducted by Morgan Stanley, pitches by diverse entrepreneurs were often times unsuccessful to investors, who were disproportionately white men, because the investors admitted to being less likely to connect to the sectors that the diverse entrepreneurs serve.[23] Because they were unfamiliar with the consumer base, they struggled to see the vision and market need being met by the entrepreneur's product.[24]

If the criteria for evaluating investment opportunities is largely reliant on whether investors are familiar with the consumer or marketplace, then that puts diverse and women entrepreneurs at a significant disadvantage. Equally important, it results in missed opportunities for investors seeking to capitalize on a broader market.

Mitigation Efforts—Tackling the Funding Gap in New Jersey

Bridging the access gap will require innovative measures and a commitment to adjusting how the industry evaluates investment opportunities.

Intentional Funding

One approach is to embrace "intentional funding"—investment strategies that deliberately invest in female- and diverse-led businesses. New Jersey is taking promising steps in this direction. By supporting and working in tandem with groups striving for a more inclusive VC ecosystem, the state is partnering with organizations that connect investors with female and diverse entrepreneurs.

In February 2020, the New Jersey Economic Development Authority, together with First Lady Tammy Murphy, joined forces with Golden Seeds, an angel investment firm, to launch the New Jersey chapter of the organization.[25] Golden Seeds is a national angel investor network committed to investing in female-led startup companies to ensure that those startups have access to the capital they need to succeed and remain competitive.[26] Founded in 2005 and headquartered in New York City, Golden Seeds has over 275 members dedicated to evaluating, funding and helping companies with at least one woman in an upper management role with an equity position.[27] Through its partnership with Golden Seeds, NJEDA is embracing the opportunity to increase capital to female-led startups.[28]

Another New Jersey-based initiative has also adopted the intentional funding model to enhance investment opportunities to diverse founders. The Black and Latino Angel Investment Fund of New Jersey, launched by the Center for Urban Entrepreneurship & Economic Development at Rutgers Business School, provides founders of color with pre-accelerator funding necessary to grow their ventures.[29] In addition to providing seed capital, the fund sponsors a capacity-building program to help technology ventures gain the training and mentorship necessary to scale up.[30]

The state has also adopted initiatives that incentivize investments in diverse and female-led startups. The Angel Tax Credit Program, which provides eligible individuals and entities investing in qualifying emerging technology companies with refundable tax credits of up to 20% of their qualified investment, also provides for an additional 5% bonus for investments in a business located in a qualified opportunity zone, low-income community or a business that is certified as minority or women-owned by the state.[31] To be eligible for the tax credit, the emerging technology company must (i) employ fewer than 225 full-time employees (75% of whom work in New Jersey); (ii) do business, employ or own capital or property in New Jersey; or (iii) or maintain a New Jersey office.[32] The company must also conduct one of the following activities in the state: (1) incur qualified research expenses; (2) conduct pilot-scale manufacturing; or (3) commercialize one or more of the following eligible technologies: advanced computing, advanced materials, biotechnology, electronic devices, information technology.[33]

The NJEDA further promotes women and diverse entrepreneurs through its NJ Accelerate Program which selected the Morgan Stanley Multicultural Innovation Lab as its first "approved accelerator."[34] Created by NJEDA to encourage startups to establish operations in New Jersey following graduation from approved U.S. accelerator programs, NJ Accelerate has committed to providing up to $250,000 per startup in direct loans to match the funding from any approved U.S. accelerator program, plus up to six months of rent support to eligible businesses.[35] To be eligible, the startup will have had to (i) successfully graduate from an approved accelerator program, (ii) set up its operations in New Jersey within six months and (iii) maintain 50% of its employees in New Jersey.[36] The program also includes a 5% bonus for startups that are certified as women and minority-owned businesses.[37]

In addition to galvanizing entrepreneur participation in accelerator programs, NJ Accelerate also encourages accelerators to launch in New Jersey. For approved accelerators, the program will match up to $25,000 for each event hosted by the accelerator in New Jersey, including "demo days" road shows, in-person classes, pitch competition and networking events, and provide an addi-

> Companies serving women and diverse customers represent significant opportunities for investors. Women and diverse groups are driving market consumption in undeniable ways—women account for 83% of all U.S. consumption; African Americans spend $1.2 trillion annually; Latinx consumers' buying power was projected to reach $1.7 trillion in 2020.

tional 5% bonus for accelerators demonstrating written policies and practices for attracting and promoting startups owned by female or minority entrepreneurs.[38]

Ditch the Pitch

While intentional funding is advancing the ball in the right direction, another approach that is gaining momentum and likely to accelerate progress in closing that gap is the "ditch the pitch" movement. In a recent article published in the *Harvard Business Review,* the authors advocated eliminating the pitching stage in the VC investment process in favor of a more data-driven approach to assessing a startup's potential and profitability.[39] Underscoring that the pitching process is prone to bias that produces gross funding imbalances, they argued that analyzing a startup's sales data was a more reliable predictor of a venture's success than the founder's ability to deliver a pitch.[40]

Early-stage sales data delivers nonbiased indicators of customer need, product fit, marketing skill, sales funnel and customer relationship management, and, ultimately, the founder's ability to assemble and manage a team to deliver results.[41] If the goal is to pick the best startups and deliver high returns for investors, advocates of this approach urge that the pitch should be dispensed entirely because it promotes a selection process that favors male-centric characteristics. Instead of listening to pitches, investors that champion the pitch-less approach support a more data-focused selection process.

Some funds gather data in online applications and select companies based on specific metrics, relying on algorithms to do the deal sourcing work.[42] Another tactic is to outsource the initial selection to accelerators.[43] One fund sourced companies based on recommendations from a partner accelerator which evaluated companies after observing their performance over several weeks.[44] Following the first evaluation, the top performers received small initial investments.[45] After a longer diligence period of six to nine months, the companies' performance were evaluated again with top performers earning an even larger investment, with the potential to receive subsequent rounds based on the companies' performance over time.[46] With this approach, the fund focused on the actual performance data from the startups and ended up with a more gender-balanced investment portfolio.[47]

Changing the Landscape

The funding gap is a deep and entrenched problem in early-stage investing that requires the use of as many tools at one's disposal. While the state has largely focused its efforts on encouraging intentional funding, it should consider ways to promote alternative investment strategies that emphasize a numbers-oriented approach to deal sourcing and evaluation.

Companies serving women and diverse customers represent significant opportunities for investors. Women and diverse groups are driving market consumption in undeniable ways—women account for 83% of all U.S. consumption; African Americans spend $1.2 trillion annually; Latinx consumers' buying power was projected to reach $1.7 trillion in 2020.[48] The sizeable buying power of these groups provides a compelling, numbers-driven case for embracing creative approaches to incentivizing investments in businesses led by people of color and women.

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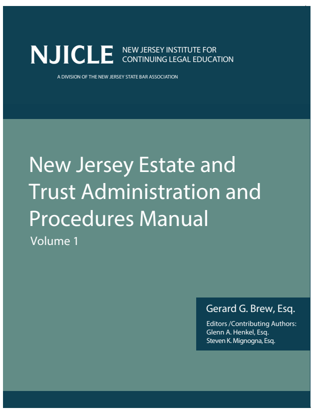

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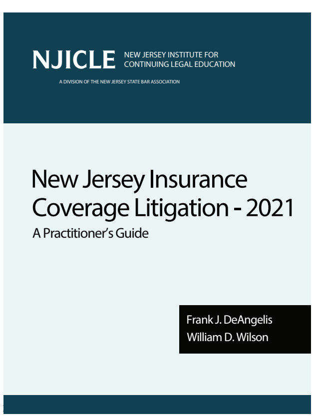

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Written by: Frank J. DeAngelis, Esq.; William D. Wilson, Esq.

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Selling to Private Equity

Not an Exit, But a New Chapter

By Jason D. Navarino and Christine N. Restrepo

All good things must come to an end, and that includes an entrepreneur's tenure as the owner of a successful business. If family or employee succession is not in the cards, the owner will likely want to monetize their interest in the business by way of a third-party sale. When business owners look to sell their businesses, third-party buyers can often be divided into two categories: strategic buyers and financial buyers. The differences between these two sets of buyers, and the impact those differences have on exit transactions and the seller's post-exit life, cannot be overstated.

Strategic buyers are likely to include competitors looking to horizontally integrate, and businesses in related industries or activities looking to expand or vertically integrate. They typically have their own management teams and their own ways of doing business, although small- and medium-sized strategic buyers may not be that experienced in the world of mergers and acquisitions. Financial buyers—typically private equity funds—on the other hand, are usually motivated not by integration, but rather investment.[1] They exist for the sole purpose of buying businesses and ultimately flipping them for a profit. "The fundamental reason behind private equity's growth and high rates of return is something that has received little attention, perhaps because it's so obvious: the firms' standard practice of buying businesses and then, after steering them through a transition of rapid performance improvement, selling them. That strategy, which embodies a combination of business and investment-portfolio management, is at the core of private equity's success."[2]

These differences in motivation on the part of the buyer can have a profound impact on the seller while a deal is being negotiated and afterwards. A financial buyer's experience in the ways of mergers and acquisitions can often expedite the transaction, but sometimes frustrate the seller if the buyer has adopted certain standard operating procedures or negotiating policies from which it will not budge. And unlike in a strategic deal, where the buyer's existing management team may be able to replace the seller and their team on day one, many financial buyers will look to the seller to continue providing leadership to the business—or at least substantial services—during a transition period. To incentivize the seller during this period, the private equity buyer is likely to rely on deferred and contingent consideration, including earnouts and rollover equity.

As with many things in life, COVID-19 has thrown a major wrench into the way private equity executives execute on their strategy. Sellers and private equity buyers must now engage in a delicate dance of balancing the interests of the parties while simultaneously dealing with a volatile market during unprecedented times of disruption and uncertainty due to the pandemic. Adaptation and adjustment are absolutely critical in this environment in order to close the deal.

In this article, we explore the various aspects of a sale to private equity that stand out in contrast to a strategic deal, including the expectation of post-closing services on the part of the seller and the target company's existing management, earnouts, and rollover equity. Along the way, we observe how the pandemic has changed the way these deals progress.

Owner's and Management's Post-Closing Relationship with the Buyer

It is a common and strategic decision for a private equity buyer to enter into employment or independent contractor agreements, effective as of the closing date, with the seller and/or key members of their management team setting forth the terms, conditions, and restrictions of such engagement post-closing. The private equity buyer and seller (and often others) must determine what those vital components of the engagement will be exactly, including whether the relationship will be that of "employer-employee" or if the individual will be engaged as an independent contractor (i.e., providing transition or consulting services), and each side must take an inventory of its long-term and short-term goals.

A private equity buyer may want to retain the target's key individuals post-closing in any capacity in order to take advantage of the skills and expertise of such individuals developed in the target's industry and the network of relationships built by such individuals with customers, lower-level employees, suppliers, vendors, and other third parties. All of this will need to be preserved to avoid having to reinvent the wheel during the private equity buyer's "holding period" of the target. A smooth transition and the appearance of continuity, at least for the short term, are equally important for private equity buyers. From an optics standpoint, keeping the target's owner and certain key individuals on board as employees for a set term post-closing may bring a sense of ease and can help with employee retention. Sudden changes at the top in addition to the ownership change may create feelings of unrest, uncertainty, and upheaval among lower-level employees—feelings that may already be pres-

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ent on account of the COVID-19 pandemic. From a flexibility standpoint, a private equity buyer may prefer to keep these key individuals on as independent contractors on a part-time basis, on an "as needed" basis, or for only a short duration post-closing—or if the buyer wants to be able to easily terminate the relationship, if necessary, without worrying about costly severance.

A target's owner and other key individuals may want to assist in the transition for only a short period of time, move on to other endeavors or "passion projects," or even ride off into the sunset of retirement. On the other hand, these key individuals may want to stay on for the long-haul and continue to have their hands in the company's anticipated rapid growth and success post-closing. In an employment agreement, these key individuals will likely insist that they receive compensation and benefits that are substantially comparable to (or higher than) that which they received immediately prior to the closing. Both sides, for very different reasons, may actually prefer to have an employment agreement in place to the extent there is an earnout in the deal (see more on this below). From the private equity buyer's perspective, an earnout incentivizes the target's owner to be committed to and invested in the success of the company post-closing—to have "skin in the game"—and an employment agreement with a fixed term can serve as evidence of that commitment to the company post-closing. As further incentive, private equity buyers may also offer bonuses to sellers and key individuals using similar performance metrics used in the determination of whether certain earnout milestones have been met. From the perspective of the target's owner, as an employee, they can still somehow be actively involved in the management of, and have a higher level of visibility into the inner workings of, the company post-closing in order to preserve and protect their earnout payment(s) during the earnout period.

Often a seller or chief executive who accepts post-closing employment with a buyer is in for a bit of "culture shock." An entrepreneur or CEO who has not had a boss in decades may now find themself needing to report "up the chain" to executives with different experiences and motivations. The transition from being the ultimate decision maker to no longer running the company can prove to be extremely difficult and even unbearable, especially if the seller or top executive built the business from the ground up or served in such capacity for an extended period of time. These individuals may find themselves looking for an exit a lot sooner than expected—well in advance of any expiration of an employment agreement term, which is why these key individuals should try to keep their employment terms (and the earnout period) as short as possible.

Regardless of the type of relationship between the private equity buyer and any key individual, each side should strive to clearly define and set forth the key individual's new role, scope of responsibility, authority, reporting structure, and any policies that such individual will be required to follow in order to properly set expectations in advance of the closing and to serve as a framework for navigating the post-closing relationship.

Often a seller or chief executive who accepts post-closing employment with a buyer is in for a bit of "culture shock." An entrepreneur or CEO who has not had a boss in decades may now find themself needing to report "up the chain" to executives with different experiences and motivations. The transition from being the ultimate decision maker to no longer running the company can prove to be extremely difficult and even unbearable, especially if the seller or top executive built the business from the ground up or served in such capacity for an extended period of time.

Earnouts

An earnout is a mechanism used to defer payment of a portion of the purchase price in mergers and acquisitions (M&A) transactions, with the deferred portion being contingent upon certain performance objectives and metrics being achieved by the target company post-closing over a pre-determined period of time. In a normal M&A market, earnouts function as a tool to bridge the "value gap" between private equity buyers and sellers. During this uncertain and unpredictable M&A climate, determining the value of a target company is even more challenging, and earnouts have become a crucial component of deals in order to get to the closing table.

Earnout provisions can be particularly advantageous for private equity buyers since such buyers are able to reduce their overall up-front payment at closing and mitigate the risk of overpaying for the target company by tying the deferred payments directly to the performance of the company post-closing. When an earnout is involved, and to the extent the target's owner and key managers are continuing to provide services to the target company post-closing, either as employees or independent contractors, private equity buyers are able to ensure that the interests of all parties are clearly aligned and focused on the success of the company—a win-win scenario for the private equity buyer. To the extent private equity buyers want additional assurances that the target's owner and key employees "keep their eyes on the prize" and maximize the target's profitability, private equity buyers may also condition the earnout payments on the continued employment (or provision of services) by the target's owner and keys employees post-closing, thereby requiring the forfeiture of such earnout payments in the event such individuals resign or are terminated for cause.

Deferring a portion of the purchase price based on the target company's achievement of certain milestones post-closing may be an extreme gamble in today's market given the pandemic, but motivated sellers must be ready to adapt and adjust if they want to close. Sellers should generally try to limit the amount of the earnout to a portion of the purchase price that they would be willing to lose given the uncertainty of the market. Further, in order to increase the likelihood of achieving the earnout targets, motivated sellers and key individuals often strive to be involved in the day-to-day operation and management of the business post-closing, and reduce the buyer's ability to sacrifice short-term profit (which would increase earnout payouts) for longer-term growth (which would maximize the business's exit potential for the buyer). Control of the business during the earnout period is often a serious point of contention during the earnout negotiation, and private equity buyers are reluctant to let go of the reins. Private equity buyers want little to no restriction on the operation of the target post-closing, and often resist all but the loosest covenants that sellers may seek in this regard.

From a tax standpoint, a seller will want assurances that an earnout is respected as a component of purchase price, and not treated as compensation, so that earnout payments are eligible for capital gain treatment. Making sure that earnout provisions are contained entirely in the purchase agreement and not in the seller's employment or consulting agreement, that the payments are tied entirely to performance and not any quantity of services rendered, and that there are certain scenarios in which the earnout may be paid even if post-closing services are not fully rendered (e.g., death or termination without cause) are helpful in this regard.

Rollover Equity

Another useful tool available to private equity buyers, in general but particularly in this chaotic environment, is rollover equity. A target's owners can "roll" a portion of their equity in the target company into the buyer's acquisition vehicle or another entity within the private equity buyer's organizational structure in lieu of receiving some cash proceeds at closing. Yet again, private equity buyers are able to take advantage of reducing their up-front payments at closing while also offering additional incentives to ensure that sellers remain aligned with the overall goals and strategy of the private equity buyer and continue focusing on the success of the target company post-closing.

As with post-closing employment and earnouts, rollovers have their advantages and disadvantages for sellers. On the one hand, a win for the buyer is a win for the seller. If the company continues to grow following the first sale, the seller in that deal will benefit from the continued appreciation in the business when the private equity owner exits the investment a few years later. But unlike in the first deal, the original owner will lack any control over the timing of the second exit, the identity of the buyer, or the price that the private equity owner is willing to accept in that deal. Moreover, if the private equity buyer flips the company to another private equity fund, that fund may seek to condition the deal on the original seller's or management team's continued involvement in the business, which could be contrary to the seller's original goal of truly exiting the business. Even before that, if the rollover equity is in an entity holding more than just the original target business, the seller must engage in diligence to make sure the amount of equity being offered is at least equal in value to the cash consideration being given up in exchange for it.

Tax considerations are even more important for the seller with respect to rollover equity, which must be carefully structured to avoid "phantom income" to the seller—having the value of the equity included in the seller's income in the year of the original sale. Under no circumstance should the deal documentation state or imply that the seller is selling all of its interest in the target and then purchasing equity in the buyer's entity. Rather, the seller should typically, in the case of an equity deal, contribute some of its stock or membership interests in the target company to the buyer's acquisition vehicle, or, in the case of an asset deal, retain equity in the target company and have the target contribute some of its assets to the acquisition vehicle (with the remaining equity or assets in each case being sold for cash or other consideration). Moreover, if the acquisition vehicle is a corporation, the seller's contribution should occur at the same time as the buyer contributes cash or the acquired assets to the vehicle, to comply with the 80% control requirement of Internal Revenue Code Section 351. In any event, tax counsel should be involved in the planning and carefully review the documentation before signing and closing.

Other Considerations

When it comes to deal structure, the general rule is that sellers tend to prefer to sell stock (or membership interests, in the case of target companies that are limited liability companies), and buyers tend to prefer to buy assets. A stock sale is a complete exit for the seller—all liabilities essentially shift to the buyer, subject only to whatever indemnification the seller agrees to. Also, in the case of a C corporation, a stock sale avoids the double taxation the seller would generally face if the corporation sold its assets—taxation of the corporation's gain on the sale of its assets, and then taxation of the shareholder's gain on their disposition of the stock. Buyers, on the other hand, tend to want to leave unknown liabilities behind with the seller, and to get "stepped up" basis in the target company's assets, allowing for the purchase price to be recovered over time by way of depreciation and amortization deductions for tax purposes. Sales of corporate stock, however, do not afford buyers this opportunity.

But private equity buyers are often less deterred by these considerations than strategic buyers when it comes to sales of stock and membership interests. As they tend to have a shorter time horizon for owning the target company, tax deductions over a period of time are often of less interest to them. Also, contracts and governmental licenses and permits, which are not always transferrable in the case of an asset deal, are often of greater importance to financial buyers that lack the pre-existing customer and governmental relationships that strategic buyers may have. This can be beneficial to sellers for liability and tax purposes.

On the other hand, private equity buyers have significant leverage to push for standardization of M&A transactional documents and procedures across multiple deals. Standardization is a powerful tool to cut down inefficiencies and keep costs low, reduce risk and uncertainty, and strategically position the private equity buyer to hone in on the substantive issues and key differences between deals, thereby leading to more targeted negotiations. Sellers will usually find they have less flexibility in these scenarios as private equity buyers can point to their track record to "win" deal points.

The vast majority of sellers will be obligated to sign restrictive covenants (e.g., non-competition, non-solicitation, non-disparagement, and confidentiality) in connection with the purchase agreement. The duration, geographic scope, business scope, and any exceptions to the restrictive covenants are all heavily negotiated, with buyers pushing for the terms to be broadly drafted and construed and to last for the longest duration possible, yet be reasonable enough to be enforceable in a court of law. A private equity buyer may have an eye toward appeasing a subsequent buyer, and a private equity buyer's ability to deliver an already negotiated non-compete or set of restrictive covenants to the next buyer after the private equity buyer's holding period ends (usually within three to five years) can be a significant selling point for the next buyer—to the detriment of the original seller.

Finally, many target companies have outstanding loans under the Paycheck Protection Program. For the first few months of the pandemic, sellers and private equity buyers were left scrambling figuring out how to deal with these loans. While the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136 (2020), which established PPP, did not prohibit the sale of businesses with PPP loans, many lenders' PPP loan documents indicated that lender consent would be required for changes of control. Moreover, the PPP affiliation rules were unforgiving of private equity funds, forcing most of them to have to aggregate their portfolio companies to determine whether they met the 500-employee ceiling on eligibility. Many funds flunked this test, meaning that, following an acquisition, a target might cease to be eligible to have a PPP loan.

The U.S. Small Business Administration eventually provided some clarity by way of a Procedural Notice,[3] effective Oct. 2, 2020, setting forth the required procedures for a "change of ownership"[4] of an entity that has received a PPP loan. In most cases, having to get SBA consent can be avoided if the target company applies for forgiveness of its PPP loan prior to the closing. If the application is not approved before the closing, the buyer funds an escrow with the lender in the outstanding amount of the loan (typically out of what would otherwise be paid to the seller at closing), which escrow is released to the seller if the application is ultimately approved and released to the lender if it is not.

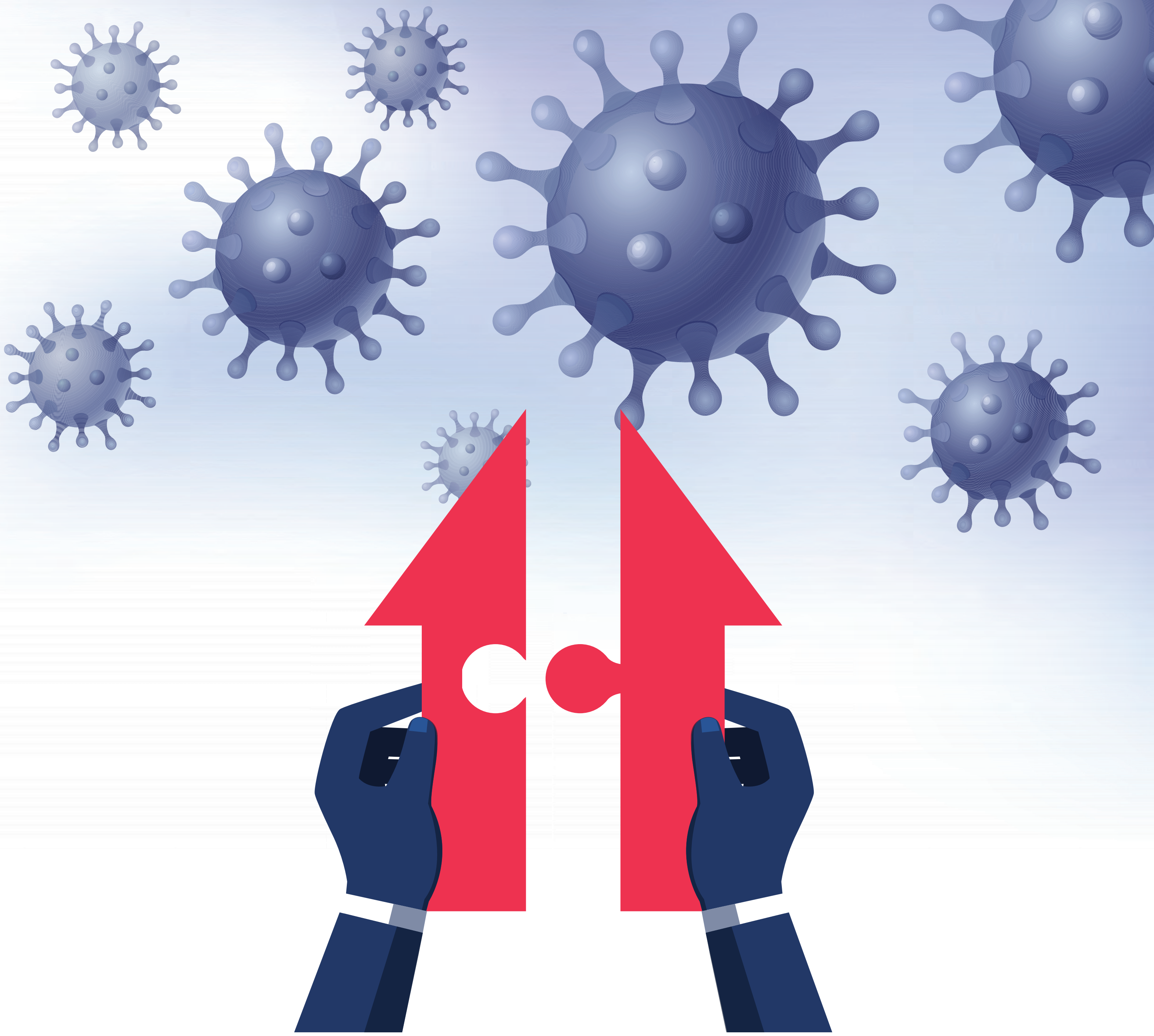
Conclusion

The private equity market offers business owners tremendous opportunity to make a lucrative exit from established businesses with a track record of success. But sellers in private equity deals must realize that their deal counterparties are likely to be highly experienced in M&A

deals, to require some post-closing commitment on the part of the seller or key managers, and to expect that at least some of the purchase price take the form of an earnout or rollover equity, delaying the seller's ultimate exit from the business. Understanding these dynamics going into the transaction can make a world of difference in terms of whether the seller is satisfied with the ultimate outcome. ⚖

Endnotes

1. Some private equity firms will, however, engage in "roll-up acquisitions"—steering their portfolio companies to horizontally or vertically integrate, in order to better position them for sale. These roll-up transactions often have some elements of strategic deals, as there are often management teams to be merged. But the financial executives leading them on the buy-side tend to manage these deals in much the same way as they do when acquiring a portfolio company. This makes sense, as those executives' ultimate goal remains the same, regardless of whether the transaction is a direct portfolio investment or a roll-up.
2. Felix Barber & Michael Goold, *The Strategic Secret of Private Equity*, Harvard Business Review (2007), *available at* hbr.org/2007/09/the-strategic-secret-of-private-equity.
3. *See* SBA Procedural Notice 5000-20057, Paycheck Protection Program Loans and Changes of Ownership, *available at* https://www.sba.gov/sites/default/files/2020-10/5000-20057-508.pdf.
4. For purposes of the PPP, the Procedural Notice states that "a 'change of ownership' will be considered to have occurred when (1) at least 20 percent of the common stock or other ownership interest of a PPP borrower (including a publicly traded entity) 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 percent 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." *Id.*



Impact of COVID-19 on Mergers and Acquisitions Deals

New Laws, Economy, Changed Ways of Doing Business Force Attorneys to Reevaluate All Aspects of Transactions

By Michael J. Zussman and Jacob G. Shulman

History will remember 2020 as the year the coronavirus wreaked havoc across the world. Despite a brief pause at the outset of the COVID-19 pandemic, middle-market companies and advisers adapted quickly and had a remarkable year engaged in mergers and acquisitions (M&A) transactions. While to some extent the transactions represented "business as usual," COVID-19 impacted all aspects of M&A transactions.

Valuation methodologies of target companies changed to discount for declines in business and allocation of risk, among other changes. The industry coined the new financial metric "EBITDA+C" (earnings before interest, taxes, depreciation, amortization, and coronavirus), and buyers expanded due diligence requests relating to employment and benefits and COVID-19 compliance and required additional post-closing escrows. Banks, landlords, vendors, and customers experienced their own impact from COVID-19, compounding delays and transaction complexities. The United States Small Business Administration and United States Department of the Treasury published and continually updated their guidance and rules[1] related to the Family First Coronavirus Response Act, as amended by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), the Paycheck Protection Program codified in 15 U.S.C. 636(a)(36) (PPP), the Consolidated Appropriations Act, 2021, and other relevant government acts.[2]

Many COVID-19 affected companies found themselves changing their M&A plans: seeking alternatives to traditional M&A, adding additional liquidity to bolster balance sheets, pausing or abandoning transactions, or changing sector focus. COVID-19's impact on a company's operations and financial health ultimately must be resolved in the transaction documents. As with all deal terms, buyers and sellers will negotiate each obligation and liability relating to COVID-19. Purchase agreements must address the status and disposition of PPP loans, furloughed and terminated employees, remote employees, representations and warranties relating to compliance with PPP loans and state and federal directives, and new indemnification obligations and escrows. This article focuses on COVID-19's effects on pre-M&A operations, the due diligence process, and changes to purchase agreement provisions from the perspective of a seller of a middle-market target company.

Company Operations

Depending on the company's line of business and ability to pivot, COVID-19 has either led to further success or decimated the business. Many companies found themselves needing to update their employee handbook to update or implement a work-from-home policy and create new in-person rules for social distancing and wearing face coverings in the office. Companies updated their business technology and cybersecurity compliance[3] and applied for PPP loans to cover anticipated shortfalls in payroll.

Employees and benefits

Remote employees pre-COVID-19 may not have been directly impacted, but their in-office colleagues, vendors, suppliers, customers, and the business itself most certainly have. If the business changed its benefits or policies, there are compliance issues that must be considered and addressed. The needs of employees and businesses needed to be balanced: emergency paid sick time or leave,[4] protection in the workplace, flexibility, reduction in benefit plans, expense reimbursement policies or other company obligations, cost of personal protective equipment (PPE), cost of lost

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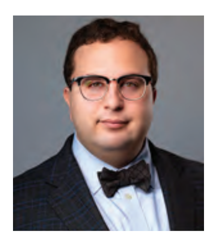

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productivity, and cost of "inefficient" use of space for proper social distancing. Each of these decisions impacted the safety of employees, but also the company policy making process, due diligence process, and allocation of risk and liability provisions of the purchase agreement.

Policies and Compliance

As state and federal government guidance progressed, companies needed to maintain compliance with their existing benefits policies, existing contractual relationships, and new COVID-19 related policies. Companies had to or should have evaluated any notice provisions under applicable law,[5] benefit plans regarding changes, and any contractual relationships that were at risk. Prior to the pandemic, material adverse change and force majeure provisions in commercial contracts did not always include pandemics and epidemics. For example, any reduction to 401(k) plan matching contributions may have required advanced or prompt notice to employees. Other operational changes may have warranted a Worker Adjustment and Retraining Notification Act (WARN Act) analysis.

PPP Loans

In addition to complying with state directives related to physical operations and changes to benefit plans and policies, companies needed to align their operations with the requirements of the PPP to qualify for a loan under the PPP which might be forgiven, or other funding, such as an Economic Injury Disaster Loan or state-level loans such as the New Jersey Economic Development Authority program.[6] The SBA outlined the parameters of the PPP loan program, which limited the interest rate and the complexity of the loan terms, among other things. Lenders scrambled to set up their loan applications, forgiveness applications, and other forms to participate in the program.

From the perspective of a target company, sellers typically deliver the target company on a cash-free and debt-free basis. That means that sellers are entitled to retain company cash, and buyers will not assume any of the debt, on the company's balance sheet. Sellers pay off debt at or prior to closing, or otherwise retain the liability.

PPP loans are simply another form of debt which buyers will not ordinarily assume in a transaction. However, due to the nature of the PPP loan terms and opportunity for forgiveness, sellers often do not pay off PPP loans prior to closing. The purchase agreement must address the mechanics and disposition of the PPP loan if it is not repaid or forgiven prior to closing. Attorneys drafting purchase agreements must carefully consider how PPP loans are characterized and defined, including whether they are included within the definition of "indebtedness." While the outstanding PPP loan technically is company indebtedness, sellers anticipating full forgiveness should seek to avoid the PPP loan affecting the purchase price or other deal metrics. On the other hand, fully or partially repaying the PPP loan is a realization of the debt and buyers must be made whole either by a reduction in the purchase price or other adjustment. The purchase agreement will also include company representations and warranties that the company has complied with the CARES Act and 15 U.S.C. § 636(a) of the Small Business Act relating to business loans, including, without limitation, the company's proper use of PPP loan proceeds, as well as indemnification for liabilities relating to the PPP loan.

If a company has satisfied the SBA requirements for loan forgiveness, namely, maintaining employee and compensation levels, spending PPP loan proceeds on payroll costs and other eligible expenses, with at least 60% of the proceeds spent on payroll costs, then the company may submit a forgiveness application for full or partial forgiveness of the PPP loan. Processing the forgiveness application may take several weeks or longer. The lenders have 60 days, and the SBA has 90 days, to review applications.

From the cash due at closing, in addition to purchase price adjustments, transaction expenses, and other escrow requirements, the buyer will deduct an amount equal to the outstanding PPP loan balance and deposit it into escrow at closing, pending the final disposition of the SBA. The PPP escrow amount may or may not be held in the same escrow account as the adjustment escrow or indemnity escrow and may or may not be subject to fees, interest, and deductions for any unforgiven amounts or other loans, such as EIDL. Upon the SBA's determination of forgiveness, any indebtedness under the PPP loan that was not forgiven will be released from escrow to the PPP lender in satisfaction of such unforgiven indebtedness, and any remaining PPP loan escrow amount will be released to the sellers.

Due Diligence

Financial Due Diligence

The main metrics for pricing a deal is how much has the company recently made, and what is the company projected to make in the short-term and middle-term. These metrics are based on changes to income from customers, the number of customers, cost of goods sold and deferred revenue, or in short, as one example, earnings before interest taxes, depreciation, amortization, based on historical financial statements (EBITDA). However, dealmakers now need to price in the impact of COVID-19, or EBITDA+C, on all the above. Adjusted EBITDA, another financial metric, could also account for lost revenues and profits; however, it is difficult to be exact in defining what was specifically lost due to COVID-19, or if there were other factors in play. Common EBITDA adjustments include special projects or one-time settlements. Common 'C' additions to EBITDA include employment changes, supply chain cost increases and disruptions, loss of revenues and profits, and other declines related to COVID-19. Changes to customer volume, volume per customer, economic terms in a contract, among other factors, all impact earnings and the company's balance sheet. Some company customers have declared bankruptcy or ceased business altogether, further impacting the company's bottom line. The buyer's tax and finance advisers will require a clear picture of all such changes and how they will impact the existing relationships with customers, suppliers, and vendors going forward.

Employment and Benefits Due Diligence

COVID-19 not only decreased profits and increased business costs, but also increased due diligence costs. Access to employees and on-site reviews are critical to deals. Additionally, due diligence requests pertaining to the impacts of COVID-19 became the primary inquiries of buyers. Buyers sought answers to whether the company modified, increased, or reduced compensation or benefits for any employees, modified or reduced employee hours, or conducted layoffs or furloughs as a direct or indirect result of COVID-19. If the answer to any of the foregoing is yes, then the buyer conducts more extensive diligence to ensure compliance with laws and guidance, many of which, such as FFCRA and the CARES Act, are new. Even more broadly, buyer's counsel can shift compliance[7] diligence onto sellers related to state and federal guidelines, including the aforementioned laws, such as tracking employee COVID-19 reactions, handling stay-at-home orders, posting and distributing notices during to FFCRA company policies, employment changes, state compliance issues based on new locations of employees working from home, safety policies,[8] WARN Act and notices to benefit changes.

In a typical M&A transaction, the company makes several representations and warranties relating to employment matters, such as the number of employees on its payroll and contractors engaged, terminations of key employees, mass layoffs or closures, and material changes in compensation or benefits. The disclosure schedules attached to the purchase agreement provide details and context for any changes outside the ordinary course or exceptions to the representations and warranties.

Due to COVID-19, in 2020, not unlike recessions and other unstable periods, companies were more likely to take extraordinary protective, reactive, and precautionary measures. Companies closed offices, terminated and furloughed employees, and reduced or deferred compensation. In response, buyers began requiring new representations and warranties in M&A purchase agreements to provide a complete picture of COVID-19's impact on the company's workforce, including changes in employment and payroll taxes. Sellers addressed most material changes in employment matters in the disclosure schedules, to disclose to buyer the employees' pre- and post-COVID-19 workplace location, changes in benefits and reduction of compensation, and lists of terminated and furloughed employees.

One consequence of company employees suddenly working remotely due to COVID-19 is unexpectedly having employees living in different states. Whether due to personal, financial, health, or family reasons, many employees moved across state lines in 2020. Depending on the state, and whether the move is intended to be permanent or temporary, different legal issues arise. Companies must determine in each state their new obligations with respect to sales tax, payroll tax, and corporate and business registrations. The purchase agreement and disclosure schedules address and resolve these new compliance obligations.

Operational Due Diligence

In addition to the above enhanced employment diligence, buyer's counsel is also enhancing operational and corporate governance due diligence. Buyers want to make sure that clients, suppliers, and other third parties material to the business are operating under a valid contract, no exceptions, reductions, cancellations, or otherwise have been implemented. On the other hand, buyer's and investor's counsel want to know that the company has not experienced any other delays, disruptions, or interruptions that has or will negatively impact or impair the company from satisfying any of their performance obligations under any contract. On top of typical diligence, there has also been a focus on force majeure clauses and other rights of parties related to performance issues. This enhanced due diligence process not only stems from counsel, but also from the increased use of representations and warranty insurance (RWI), which increases the teams of lawyers reviewing company operations. RWI also leads to more fulsome diligence and disclosures by way of fulsome representations and warranties in the purchase agreement.

COVID-19 and related government acts also impact other aspects of the deal besides diligence and the purchase agreement. For example, effective Oct. 2, 2020, the SBA provided lenders with a procedural notice outlining required procedures for loan forgiveness for an entity that is undergoing a change of ownership.[9] Prior to Oct. 2, 2020, some lenders were hesitant to provide consent to a change of control, and deals were held in limbo as they wait for lender internal processes to review an ever-growing bank of guidance. Now, with clearer guidance, lenders can expedite the process on their end, without SBA consent.

Conclusion

COVID-19 has had a tremendous impact on economies, businesses, and people's lives in the United States and across the world. It is no surprise that M&A and corporate attorneys and advisers must reevaluate and reconsider every aspect of a transaction in light of the effect of COVID-19 on their clients, and their clients' customers, employees, and vendors, as well as all those of all parties to a transaction. ⚖

Endnotes

1. On March 27, 2020, the CARES Act was signed into law. For more on the CARES Act, see "Coronavirus Aid, Relief, and Economic Security Act (CARES Act) – S.3548," available at: olenderfeldman.com/sba-documentation-checklist-and-paycheck-protection-program-treasury-guidance-update/. For more on interim final rules and guidance in early April, see (1) "SBA Documentation Checklist and Paycheck Protection Program Treasury Guidance Update April 3, 2020," available at: olenderfeldman.com/sba-documentation-checklist-and-paycheck-protection-program-treasury-guidance-update/; (2) "Paycheck Protection Program Loans Update April 8, 2020," available at: olenderfeldman.com/paycheck-protection-program-loans-update-april-8-2020/; and (3) "Paycheck Protection Program Second Interim Final Rule Summary – April 16, 2020," available at: olenderfeldman.com/paycheck-protection-program-second-interim-final-rule-summary-april-16-2020/.
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3. For more on data privacy and security, see "Data Privacy & Security Check-Up (the other 'PPP') – Working From Home During COVID-19," available at: olenderfeldman.com/data-privacy-security-check-up-the-other-ppp-working-from-home-during-covid-19/.
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5. For more on FFCRA notice requirements, see "Updated Guidance on Notice Requirements and Furloughed Employees under the Families First Coronavirus Relief Act," available at: olenderfeldman.com/updated-guidance-on-notice-requirements-and-furloughed-employees-under-the-families-first-coronavirus-relief-act/.
6. For more on the NJEDA program, see "NJEDA Providing Loans and Grants to Small Businesses Impacted by COVID-19," available at: olenderfeldman.com/njeda-providing-loans-and-grants-to-small-businesses-impacted-by-covid-19/. For an overview, see "SBA Loans for Small Businesses Impacted by Coronavirus (COVID-19)," available at: olenderfeldman.com/sba-loans-for-small-businesses-impacted-by-coronavirus-covid-19/.
7. For more on PPP loan compliance, see (1) "If You Are Seeking a Loan Under the CARES Act, Compliance is Key," available at: olenderfeldman.com/if-you-are-seeking-a-loan-under-the-cares-act-compliance-is-key/; (2) "Paycheck Protection Program (PPP) Frequently Asked Questions Regarding Spending Loan Proceeds," available at: olenderfeldman.com/paycheck-protection-program-ppp-frequently-asked-questions-regarding-spending-loan-proceeds/.
8. For more on workforce reintegration planning and safety, see "COVID-19 Workforce Reintegration Planning," available at: olenderfeldman.com/covid-19-workforce-reintegration-planning/.
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Earnouts a Complicated but Useful Option in Mergers and Acquisitions

By W. Raymond Felton

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The purchase price is an integral component of any purchase and sale of an operating business, if not the integral component. As in the purchase and sale of anything, the seller and the buyer often have different opinions about a fair and agreeable price. In the context of the sale of a business, the parties will sometimes bridge those differences through a technique commonly referred to as an earnout. While at first glance an earnout may seem to be an ideal solution to the purchase price dilemma, transactional attorneys need to be aware of the many pitfalls inherent in the structure, documentation and implementation of an earnout.

What is an Earnout?

Essentially, an earnout is a portion of the purchase price for a business that is contingent on some post-closing events or criteria, typically the performance of the business that was sold during a defined period of time after the closing. An earnout can be used in asset purchase, stock purchase and merger transactions but as discussed below it is imperative to identify the post-closing business to which the earnout applies, and the structure of the deal as an asset, stock or merger transaction may impact that issue.

An earnout should be distinguished from a deferred purchase price where the buyer is obligated to pay a sum certain over time after the closing, often evidenced by a promissory note. In those situations, the payment is due regardless of the performance of the business, and subject only to the creditworthiness of the buyer. However, not unlike the situation with a deferred purchase price, counsel to a seller in a sale involving an earnout should consider whether the earnout payment, if earned, shall be secured by collateral or subject to third-party guarantees.

In most situations, the seller will incur income tax on the earnout payment at the time it is earned and paid, not at the closing, but the income tax aspects of an earnout payment should be considered along with the other issues discussed below.

In most sale transactions with an earnout, there is also a portion of the purchase price payable at the closing so the earnout is not the entire purchase price. There are rare transactions where the total purchase price is in the earnout, for example, in an early-stage company that has yet to generate revenue. In the more typical case where the earnout supplements a base purchase price, the earnout can constitute a substantial percentage of the total price if the earnout is maximized.

Purpose of an Earnout

Earnouts are used to bridge the gap between the opinions of the seller and the buyer as to the value of the business being sold. As a general rule, the value is a function of the revenue and earnings the business generates. While historical revenue and earnings can be useful in that regard, the buyer is most interested in what those amounts will be in the future. As with any ongoing business, a number of factors both internal and external to the business will impact future results. Many of them may be unexpected and challenging to resolve by even the best managers, the COVID-19 pandemic being an obvious example. Sellers will naturally extol the bright future the business will enjoy, perhaps because of new products about to be rolled out. Buyers will counter by saying they do not want to pay for hopes and dreams, but only for actual results. This may lead to an earnout to resolve the different perspectives. In its most simplistic formulation, the buyer says to the seller, "If the business does this post-closing, I'll pay you that." Defining and implementing "this" and "that" in the previous sentence is a large part of what follows in this article.

While earnout payments are often based upon financial metrics, they can instead be triggered by other objective measures. For example, customer retention is often a key concern of a buyer, particularly where a significant percentage of the business's sales are concentrated in a small number of customers. That could lead to an earnout in which the buyer pays an additional sum if a particular group of customers continues to purchase products at a defined minimum level for somewhere between 12 and 24 months after the closing. Other earnouts could be realized based upon employee retention, obtaining regulatory approval for a new product—for example from the Food and Drug Administration, or integration of the seller's business into the buyer's operations, however that is defined. However, financial performance is the most common type of earnout, and we will turn our attention to the issues this raises for the transactional attorney.

Terms of the Earnout

An earnout that is premised upon financial performance raises the following definitional questions:

- What is being measured: sales, gross profit, EBITDA (earnings before interest taxes, depreciation and amortization), net income?
- What is the business unit subject to measurement?
- Over what time period will this measurement occur?
- How does the measurement lead to the earnout payment calculation?
- How much control does the seller have over the business during the measurement period?
- What reporting requirements does the buyer have to the seller and what rights does the seller have to examine the buyer's records?
- How are disputes resolved?

We will discuss each of these questions in order. Starting with the issue of what is being measured, an understanding of basic accounting concepts is imperative. Nevertheless, the transactional attorney should work closely with the client's accountants on this, regardless of whether the client is the seller or the buyer. The correct terminology is crucial to a well-crafted earnout provision, and accounting is necessarily implicated. While earnings or net profits are the ultimate goal for buyers, the earnings generated from a particular volume of sales can differ dramatically from what the seller may have expected, or from what the seller would have achieved based on that level of sales. The buyer, very often a larger company than the seller, may have substantially greater corporate overhead expenses than the seller. The buyer may have different accounting policies regarding revenue recognition, cost allocation and other concepts that reduce net income. Thus, a seller will frequently negotiate for an earnout tied to sales as to not to be concerned about the impact of the buyer's accounting methodology on the earnout. Even so, measuring net sales does not remove all subjectivity from the accounting process, and seller's counsel needs to be diligent in defining exactly how financial results will be measured, working closely with the seller's accountants.

The next item to consider is what business unit is subject to measurement for earnout purposes. The natural response to this is that it is the same business that the seller sold. However, businesses are dynamic and evolving organizations, in particular following a change in ownership. If the buyer is a so-called financial buyer, meaning a private equity firm, it may be feasible to keep the business segregated from the rest of the buyer's portfolio and maintain the separate identity of the business that was sold. On the other hand, if the buyer is a competitor or in a complementary business, it will quite likely integrate the acquired business with its existing operations, thereby making it a challenge to reach the sales or, worse yet, the profits of the acquired business. Other concerns for the seller may be the buyer's ability to shift customers from the acquired business to other areas of the buyer's operations, thereby depleting the earnout while the buyer still enjoys those sales. Buyers will tell sellers that the buyer has a vested interest in the seller maximizing the earnout, but that is typically much too simplistic. Another area to be addressed on this topic is the treatment of the seller's products being sold to the buyer's pre-existing customers and the buyer's existing products being sold to the seller's customers. It is imperative that these issues be discussed, negotiated and documented.

The period of time being measured for the earnout is less challenging but still requires attention. While there is no set limit, most earnouts cover at least one year and at most three years. In a longer earnout period, the documents should address what units or units of time are subject to the calculation, whether monthly, quarterly, annually or just the entire earnout period. For instance, in a three-year earnout period measured annually, will carryforward and carryback concepts be employed?

Similarly, calculating the earnout payment once the criteria have been measured and agreed upon should not be too challenging. A typical formula would simply apply a percentage to the resulting number, whether sales, net profit or whatever, so that is simply arithmetic.

On the other hand, the issue of the seller's control over the operation of the business during the earnout period is often heavily negotiated. Sellers may enter into earnout negotiations with the expectation that the buyer will operate the business more or less the same way the seller did. Buyers may enter the same negotiations with the attitude that they bought the business and now own it and are free to operate it as they choose. While no reported decision in New Jersey has addressed this question in the earnout context, the Delaware case law is clear that buyers have no obligation to operate the acquired business to maximize an earnout. Moreover, the Delaware courts have held that the implied covenant of good faith and fair dealing in contract law does not equate to an implied covenant to maximize an earnout.[1] Without debating the merits of the case law on this issue, it is incumbent on the seller's attorney to be aware of and negotiate the best possible post-closing covenants for the seller. Since those negotiations may result in fairly weak covenants or no covenants at all, seller's counsel should advise the seller of the pitfalls and risks associated with that result.

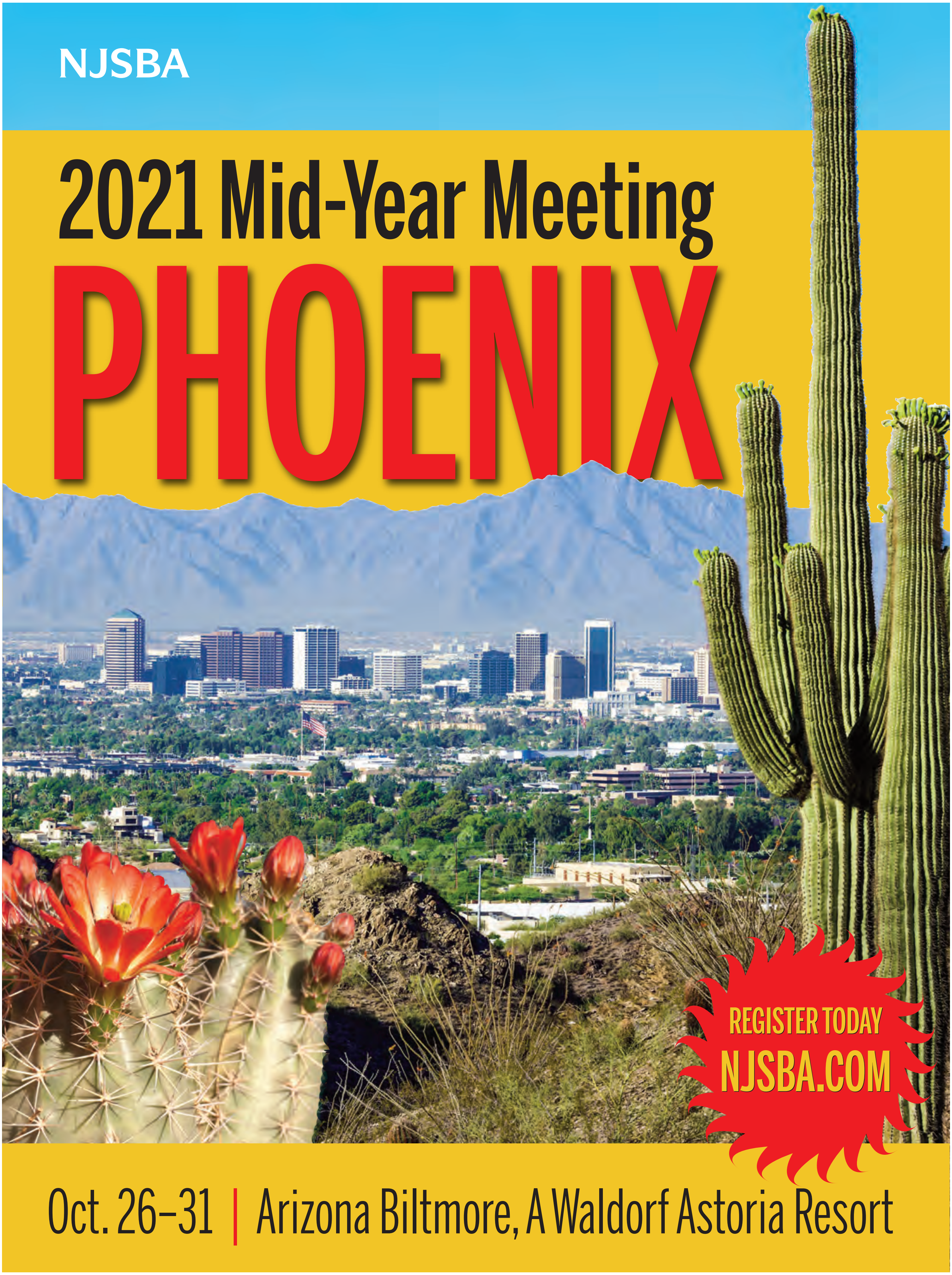
The next item to consider in negotiating earnout language is the buyer's obligation to report relevant results to the seller and the seller's right to review the buyer's records and supporting data. Of course, the seller will expect frequent updates, depending on the nature of the earnout criteria. This is not ordinarily a contentious issue in negotiating the purchase agreement, but can sometimes be challenging for a seller trying to implement its contractual rights.

The final topic covered in a properly crafted earnout provision is dispute resolution. Most such provisions employ alternative dispute resolution mechanisms rather than litigation. When the earnout criteria are financial, as is often the case, the decision-maker or neutral is usually an accountant or accounting firm and not an attorney or retired judge. If the issues revolve around accounting, this makes sense. If there are issues regarding an alleged breach of the buyer's covenants to operate the business a particular way, question whether it's appropriate for an accountant to resolve. Also consider whether to employ so-called baseball arbitration where the arbitrator can only choose the seller's position or the buyer's and no other. As in Major League Baseball salary arbitration, that structure frequently leads to a negotiated settlement without the need for a hearing or other proceeding.

In conclusion, properly structured earnouts can be useful in bridging valuation gaps between a buyer and seller. However, they are complicated mechanisms that must be carefully thought through, discussed with clients and meticulously documented to avoid problems in their implementation.⚖

Endnote

1. See, e.g., *Edinburgh Holdings, Inc. v. Education Affiliates, Inc.,* 2018 WL 2727542 (Del. Ch. June 6, 2018) and *Collab9, LLC v. En Pointe Technologies Sales, LLC and PMC, Inc.,* 2019 WL 4454412 (Del. Ch. September 17, 2019). An excellent article discussing the Delaware case law on this topic is *The Enduring Allure and Perennial Pitfalls of Earnouts* (January 2018), corpgov.law.harvard.edu/2018/02/10/the-enduring-allure-and-perennial-pitfalls-of-earnouts/ by Gail Weinstein, Robert C. Schwenkel, and David L. Shaw, Fried, Frank, Harris, Shriver & Jacobson LLP (February 10, 2018).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A Guide to Private Equity Investment in Health Care

By Grace D. Mack and Michael F. Schaff

Health care entities are met with both significant challenges and new opportunities in the current environment. The decision to partner with a private equity firm has become an alternative strategy for consideration by many physician practices and health care providers. Other choices include remaining as an unaffiliated private practice or joining or joint venturing with a hospital. The choice is not a "one size fits all" and depends on many factors. This article provides a guide to the legal and practical issues for a health care entity to consider when reviewing potential private equity investment transactions.

1.1 The Rise in Private Equity Interest in the Health Care Arena

After the enactment of the Affordable Care Act, private equity companies' interest in investing in the health care sector intensified. In addition, U.S. health care annual spending recently reached $3.8 trillion or $11,582 per person.[1] As a share of the nation's Gross Domestic Product, health spending accounts for 17.7%.[2]

Private equity companies see value in health care and may offer the capital needed by some health care entities and professional practices to implement costly administrative functions such as data analytics and population health management tools. These investments may reduce costs and increase efficiency. In addition, the ever-expanding administrative duties of running a professional practice has added to practitioners' frustrations and increased their desire to reduce their administrative burdens, focus primarily on their professional practice, and secure an exit strategy for retirement.

1.2 Recent Health Care Private Equity Deals

Health care private equity had a banner year in both 2019 and 2020, closing out a noteworthy decade of activity.[3] There were 709 private equity deals in health care in 2019 and the total disclosed deal value in 2019 reached $78.9 billion, the highest on record.[4]

1.3 Chasing Unicorns

Health care was also a significant player in the "unicorn" class of 2020 with 11 health care start-ups reaching a valuation of $1 billion or more.[5] The exponential rise in demand for certain health care services and products during COVID-19 also affected private equity and venture capital investing trends. According to PitchBook, one health care startup, MDLive, a telehealth platform, raised $75 million at a $1 billion valuation.[6]

1.4 The Typical Private Equity Deal and Business Model

Although not all private equity arrangements are the same, private equity firms are typically structured as limited partnerships with each private equity fund a special purpose entity. Given the inherent risk and illiquidity of private companies, private equity investors are generally looking for meaningful internal rates of return after closing.

A. Multiple of EBITDA

The most common valuation method used in private equity deals in the health care sector is a multiple of EBITDA.

EBITDA or "Earnings before interest, tax, depreciation, and amortization" is the income derived from the company's operations before non-cash expenses, income taxes, or interest expense. EBITDA is viewed as a benchmark of a company's financial performance in terms of profitability without regard to certain non-operational expenses.

To determine the value of an enterprise using a multiple of EBITDA, a company's EBITBA is multiplied by an agreed-upon multiple. For example, if the company's EBITDA is $2 million and the valuation multiple is 8 then the company's valuation is $16 million.

Although valuation multiples are a useful methodology to determine the value of a company, the company's real valuation is much more involved than just multiplying the company's EBITDA by the valuation multiple. There are many factors that affect EBITDA and the multiple used in the valuation, such as the amount of rollover equity and post transaction compensation arrangements.

In the past, the range of multiples of EBITDA in the health care sector varied greatly, generally ranging from 3-14. According to the Bain Company, Inc. Global Private Equity Report 2018, (2018 Bain Private Equity Report),[7] "retail health businesses with fewer than 10 outlets have been commanding multiples of around four to seven times EBITDA, those with 10 to 50 clinics are selling for seven to nine times, and some marquee assets with more than 50 clinics are trading in the low teens."[8] Recent activity has indicated that multiples may even reach 15 or more.

Due to the complexity of the valuation process, parties in the private equity deal should engage experienced financial advisers to assist in the preparation and review of the valuation.

B. Rollover Equity

Many private equity deals include the issuance of rollover equity. In these instances, one or more of the physicians or health entity owners will roll over part of the proceeds or ownership interest into the new private equity manage-

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In CPOM states, such as New Jersey and New York, the CPOM doctrine generally prohibits a business entity, such as a private equity investor, from practicing medicine or employing a physician. To comply with the CPOM restrictions, the business people may form a management or administrative services organization (MSO) which may provide space, equipment, non-clinical personnel, supplies and management services to the professional practice.

ment entity. Depending upon the valuation given to the enterprise, the physician or other health care entity owners may be asked to retain between 10% and 40% of their ownership in the recapitalized entity.

Key Legal Issues

2.1 Beware of State Law Restrictions

A. Corporate Practice of Medicine Restrictions

In particular, state law must be reviewed for compliance with any applicable corporate practice of medicine (CPOM) restrictions. The CPOM has become an essential consideration in structuring transactions with private equity firms involving all types of licensed professionals. This analysis is state specific.[9] The corporate practice of medicine doctrine essentially prohibits any person other than a licensed professional from owning or controlling or deriving the profits from a professional practice. The rationale for the doctrine is that individual physicians/licensees, not entities, should be licensed to practice the profession.

In CPOM states, such as New Jersey and New York, the CPOM doctrine generally prohibits a business entity, such as a private equity investor, from practicing medicine or employing a physician. To comply with the CPOM restrictions, the business people may form a management or administrative services organization (MSO) which may provide space,[10] equipment, non-clinical personnel, supplies and management services to the professional practice. The MSO may be set up as either a limited liability company or corporation that is owned in whole or in part by the private equity entity, or its affiliate, separate from the practice itself.

The MSO is paid a fee for providing non-clinical services to the medical practice. The fee should be fair market value and commercially reasonable for the services provided.

Management arrangements need to be carefully analyzed to ensure that these transactions are properly structured. In CPOM states, it is essential that the MSO not interfere with the professional's medical (clinical) judgment or otherwise exert control over the medical aspects of the medical practice. In certain CPOM states, such as New Jersey, the medical practice must be owned entirely by licensed professionals.[11]

B. The Current CPOM Environment

As private equity and management arrangements become more common, regulation and enforcement in the coming years may increase. Recently, state courts and attorneys general have been focusing more on compliance with these CPOM laws. For example, in *Allstate Ins. Co. v. Northfield Medical Center, P.C.*,[12] the New Jersey Supreme Court ruled that, based on the facts of the relationship, an MSO was the practical owner of the practice and thus the structure was a violation of the NJ CPOM. In the *Matter of Andrew Carothers, M.D., P.C.*,[13] a New York court held that a non-physician owned MSO was engaged in the corporate practice of medicine.

The corporate practice doctrine may apply to other types of licensed health care professionals. In fact, one very active area of private equity (PE) activity is dental practice management. Many states, including New Jersey, have corporate practice of dentistry restrictions similar or more restrictive than CPOM.[14] As a result, there has been increased focus on arrangements with dental practice MSOs. For example, on June 18, 2015, the New York Attorney General and Aspen Dental Management Inc. agreed to an Assurance of Discontinuance after an Office of Attorney General investigation into ADMI's business practices which raised concerns under the New York corporate practice of dentistry restrictions.

2.2 Considerations as to the Structure of PE/Medical Practice transactions

It is important to consult with a tax adviser early in the development of a private equity transaction to ensure all decisions are made with a complete understanding of the tax consequences, including but not limited to, advice as the sale transaction and the equity rollover.

For example, if the transaction is structured as a stock/equity sale by the individual owner, the sale may be taxed at capital gains tax rate. This avoids double taxation. In addition, depending on the contractual provisions, the need to obtain third-party consents may be avoided with a stock/equity sale. It may also enable the acquirer to retain payor contracts which are important to a health care entity. However, if a stock/equity sale is utilized, all liabilities will remain with the health care entity which becomes the responsibility of the acquirer. This is a significant factor in the health care industry given the risk that government and commercial payors make seek overpayment reimbursement in the future. This factor often drives the decision on the structure of the deal as an asset or stock/equity purchase.

2.3 Fraud and Abuse Laws: Anti-Kickback/False Claims Act Liability/Self-Referral Laws

In connection with a health care PE transaction, all compensation, investment and other financial arrangements with employees, contractors, practice owners and referral sources must be reviewed under the federal and state fraud and abuse laws.

A. Anti-Kickback Laws

PE arrangements in the health care sector must be structured to comply with the Federal Anti-Kickback (AKS).[15] Similar to the Federal AKS law, many states also have prohibitions on kickback arrangements. State anti-kickback laws may differ significantly from the Federal AKS law. Therefore, PE deals must be carefully structured to comply with both federal and state AKS laws.

B. The False Claims Act

The Federal False Claims Act[16] imposes liability on any person who submits a claim to the federal government that the person knows, or should know, is false. A provider who submits a bill to Medicare for medical services that they did not provide would be in violation of the FCA.

In addition, the FCA provides that private parties may bring an action on behalf of the United States.[17] These private parties, known as "*qui tam* relators," may share in a percentage of the proceeds from an FCA action or settlement.

Similar to the federal laws, many states also have prohibitions on false claims.

In addition to fines and treble damages, penalties may include imprisonment and/or exclusion from other programs.

C. Self-Referral Laws

A careful self-referral analysis will have to be done in connection with each potential referral source to and from the health care participants in the private equity deal. Generally, the federal Stark Law[18] prohibits physicians and other licensed health care providers from referring a patient for Medicare "designated health services" to a person or entity in which the physician or an immediate family member of the physician has a financial relationship, including ownership and compensation.

Many states, including New Jersey, have comparable self-referral laws.[19] As with the state anti-kickback statutes, state self-referral laws may be much broader than the federal Stark Law.

2.4 Restrictive Covenants

The inclusion of restrictive covenants in private equity deals is an important deal consideration. Restrictive covenants may be contained in several different agreements in a private equity deal, including the acquisition agreements, physician services agreements, management services agreements, and employments agreements. Restrictive covenants include confidentiality, non-solicitation, non-interference and covenants not to compete. The enforcement of the covenants will depend on state law, the type of agreement, the parties involved and the scope and term. For example, a covenant contained in an acquisition agreement may be treated differently than a covenant contained in an employment agreement; a private equity or management firm seeking to enforce a covenant with respect to a professional practice may be treated differently than a professional entity seeking to enforce the covenant with respect to a professional practice.

Many states will enforce covenants not to compete but limit the scope to a reasonable time and geographic restriction. In some cases, the courts will "blue pencil" the covenant to conform with the court's determination of reasonableness.

2.5 Fee Splitting Laws

Private equity financial arrangements must be analyzed to ensure compliance with any state fee-splitting laws. Many states have stringent fee splitting laws that prohibit the sharing of fees obtained from providing professional health care services with non-licensees. Many of the fee splitting prohibitions are contained in the various licensing boards' rules and regulations or in the definition of unprofessional conduct. For example, New York regulations[20] prohibit any fee-splitting arrangement whereby the amount received in payment for furnishing space, facilities, equipment or personnel services used by a professional licensee constitutes a percentage of, or is otherwise dependent upon, the income or receipts of the licensee from such practice. Thus, any arrangement in New York must not include any fee which is a percentage of the income or receipts of the practice.

2.6 Licensure Requirements

Licensed professionals and facilities in nearly every state are subject to stringent regulations governing many aspects of their operation. If an entity holds any licenses, certifications or accreditations, the transaction with the private equity firm may trigger change of ownership, notification or other filing requirements.

As a result, in all private equity deals in the health care sector, licensure laws must be carefully examined to ensure that any type of collaboration between a licensed facility and other health care providers does not trigger any type of approval from the respective licensing agency. Parties should review all certificates of need, licenses, certifications, registrations, permits and accreditations held by the health care entity.

Certain activities provided by the private equity management entity may trigger license, registration or certification requirements under state law. These may include acting as an employment/placement agency or third billing company or third-party administrator.

2.7 Securities and Antitrust Laws

If the transaction involves the issuance of securities or potential antitrust issues, it should be reviewed with securities and/or antitrust counsel for compliance with these laws.

2.8 Payor Related Issues

Another important factor is payor relationships and reimbursement. Managed care contracts need to be reviewed and may need to be renegotiated if the transaction is a triggering event under the payor arrangement. In some cases, Medicare and Medicaid provider numbers may be affected and payor notification is required.

Another payor related issue to be negotiated and included in the transaction documents is liability and indemnification for future payor recoupment relating to pre-closing services.

2.9 COVID-19 Considerations

The COVID-19 pandemic has affected PE transactions at every stage of the process. Parties must address COVID-19-related issues, such as the effect of the pandemic on provider revenue and the evaluation receipt of stimulus funds under the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act), including loans under the Paycheck Protection Program and payments from the Public Health and Social Services Emergency Fund (HHS Provider Relief Fund), the Medicare Advance Program, and paid leave tax credits under the Families First Coronavirus Response Act.

Some Practical Tips

To avoid surprises in a PE deal, health care providers should engage in their own due diligence and regulatory review prior to negotiation with a PE firm. Issues which are identified for the first time during the private equity firm's due diligence review may result in delays in the transaction, impact the valuation and purchase price, and affect the credibility of the provider. Many of these issues, such as overpayments or regulatory concerns, can be addressed prior to the deal or disclosed to the private equity firm with a description of the affirmative steps taken by the provider.

Another useful tool for addressing some of the risk involved in larger private equity deals is the purchase of representation & warranty insurance. As a result of the increase in private equity transactions in health care, it is becoming more common place to consider representation and warranty insurance to absorb some or all of the risk of the investment. We expect this trend to continue and evolve. Although insurance will not replace indemnification, guaranties, escrows and holdbacks, it may serve as an additional risk management tool to decrease the risk in the deal.

The Ultimate Consideration

In addition to the practical and legal issues in this guide, the most significant consideration facing physicians and health care companies in their review of the available alternatives is their ability to deliver sound patient care. All private equity arrangements with physicians, health care professionals and health care entities should be structured and operated to preserve the autonomy of the health care professionals in the practice of their professions and the delivery of patient care. ⚖

Endnotes

1. CMS, National Health Expenditures Accounts (NHEA) 2019 Highlights
2. *Id.*
3. Global Healthcare Private Equity and Corporate M&A Report 2020, Bain & Company, Inc. (March 2020)
4. *Id.*
5. PitchBook, 2020's Unicorns Highlight Shift in Venture Capital Funding Trends, Priyamvada Mathur (November 6, 2020)
6. *Id.*
7. Global Private Equity Report 2018, Bain & Company, Inc.
8. *Id.*
9. The AHLA Corporate Practice of Medicine: A Fifty State Survey is available for purchase through the American Health Lawyers Association.
10. Note that the lease of a dental office in New Jersey by an MSO may implicate the corporate practice of dentistry under NJSA 45:6-19
11. NJAC 13:35-6.16(f).
12. *Allstate Ins. Co. v. Northfield Medical Center, P.C.*, 228 N.J. 596 (2017).
13. *Andrew Carothers, M.D., PC v. Progressive Ins. Co* (2017 NY Slip Op. 02614) Appellate Division, Second Dept.
14. NJSA 45:6-19
15. 42 U.S.C. 1320a-7b(b).
16. 31 U.S. Code § 3729
17. 31 U.S.C. 3730.
18. 42 U.S.C. 1395n(n).
19. N.J.S.A. 45:9-22.4-22.9
20. 8 N.Y. C.R.R. 29.1(b).


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