Top Three Downstream Issues in Physician Private Equity Transactions

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We have posted previously in Healthcare Law Today related to physician private equity transactions, commonly called “recapitalizations.” Most of the discussions have been about the “who,” the “why” and the “how” of these transactions. What we haven’t yet discussed are the issues that may arise following the closing of one of these transactions. While the impact of the issues generally emerge post-closing, many can be addressed, or at least recognized, at the time the original transaction is negotiated. Following are three material issues that often surface:

1. Rollover Equity

As we’ve discussed in other blogs in Healthcare Law Today the sale of a so-called platform practice generally results in the selling physicians receiving both cash and equity in the recapitalized company (rollover equity). Buyers demand that selling physicians retain a certain percentage of their sale proceeds in the form of rollover equity in order to ensure that the physicians have strong incentives to help grow the recapitalized business.

This equity has the potential to grow in value and provide the selling physicians with additional profitability from the original transaction so long as the physicians are afforded the opportunity to dispose of the equity. This puts pressure on the terms of the transfer and disposition of this equity. For example, both sides will want to consider the circumstances under which a physician can, or will be required to, sell back his or her equity and the price at which it will be sold. Common buy-sell events include death, disability, leaving the practice through retirement or otherwise, or breaching the operating agreement or a restrictive covenant. Sales in certain adverse consequences will often result in some sort of reduction in purchase price below the fair market value of the equity; these prices and penalties need to be negotiated carefully.

In addition, well-counseled physicians should be allowed to participate in a subsequent sale of the company by their private equity partner. Commonly called “tag along” and “drag along” provisions, these terms are negotiated during the original recapitalization transaction. For example, physicians are generally afforded the right to “tag along” in a sale of equity by their private equity partner. Note, however, that as purchase price multiples have risen and as the possibility of fund-to-fund sales has increased in certain instances, physicians are being required to roll over, a second time, a certain portion their rollover equity in post-recapitalization sales. Conversely, private equity sponsors generally have the ability to “drag” their physicians partners along in an equity sale; in this case, care should be taken to ensure that the physicians have the right to participate in the sale on substantially the same terms as the sponsor.

2. Capital Calls and Dilution (Bolt Ons)

Physician recapitalization strategies don’t end with the acquisition of the platform practice; quite to the contrary. These businesses grow through the acquisition of additional practices that are often referred to as “bolt on” acquisitions. Such a growth plan requires capital. Generally, it is expected that a combination of debt and cash flow will provide the capital necessary to buy these bolt on practices. However, things don’t always go according to plan. In those instances, the equity holders are asked to contribute capital to the recapitalized company in order to provide the funds necessary to grow the business.
Standard provisions in recapitalization documents include terms related to the ability of the governing body of the recapitalized company to issue calls for capital. Well advised physician equity holders will seek preemptive rights that allow them to invest new money as well, so as to avoid dilution, subject to certain exceptions. Preemptive rights are valuable, but they come with a price. Exercising these rights requires the equity holders taking advantage of these rights to pay fair market value for new equity. Preemptive rights, however, can be both a blessing and a curse. Physician investors don’t always expect that they will need to dip into their own reserves to avoid being diluted, but it happens. Candid discussion of growth plans, capitalization requirements and alternatives is advised during the course of negotiations.

3. Tax Issues

Depending upon how the original physician practice was treated from a tax perspective, there may be tax consequences upon the later disposition of equity in the recapitalized practice by the original physician owners. For example, if the practice was a subchapter S corporation for tax purposes, it is often necessary that the physician investors (assuming there is more than one) hold their rollover equity in an equity holding company. Meaning, the physicians own stock in the equity holding company and the equity holding company owns the rollover equity in the recapitalized practice, that also elects S corporation status. This is done to avoid the recognition of built-in gains on the rollover equity. However, when any of the physician equity holders exits the practice and sells his or her equity in the holding company, a tax will be triggered at that time, and this tax is borne by all physician investors, whether or not they have sold any equity. In that instance, it is necessary that the physician owners structure their arrangement to require any exiting physician investor to pay the taxes incurred by the remaining physician investors so as to avoid an unfair, and unexpected tax result.

Physician recapitalization transactions are complicated and much time and effort is spent on structuring the sale of the practice. However, care should be taken to better appreciate the downstream impact of the terms of the original transaction.

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