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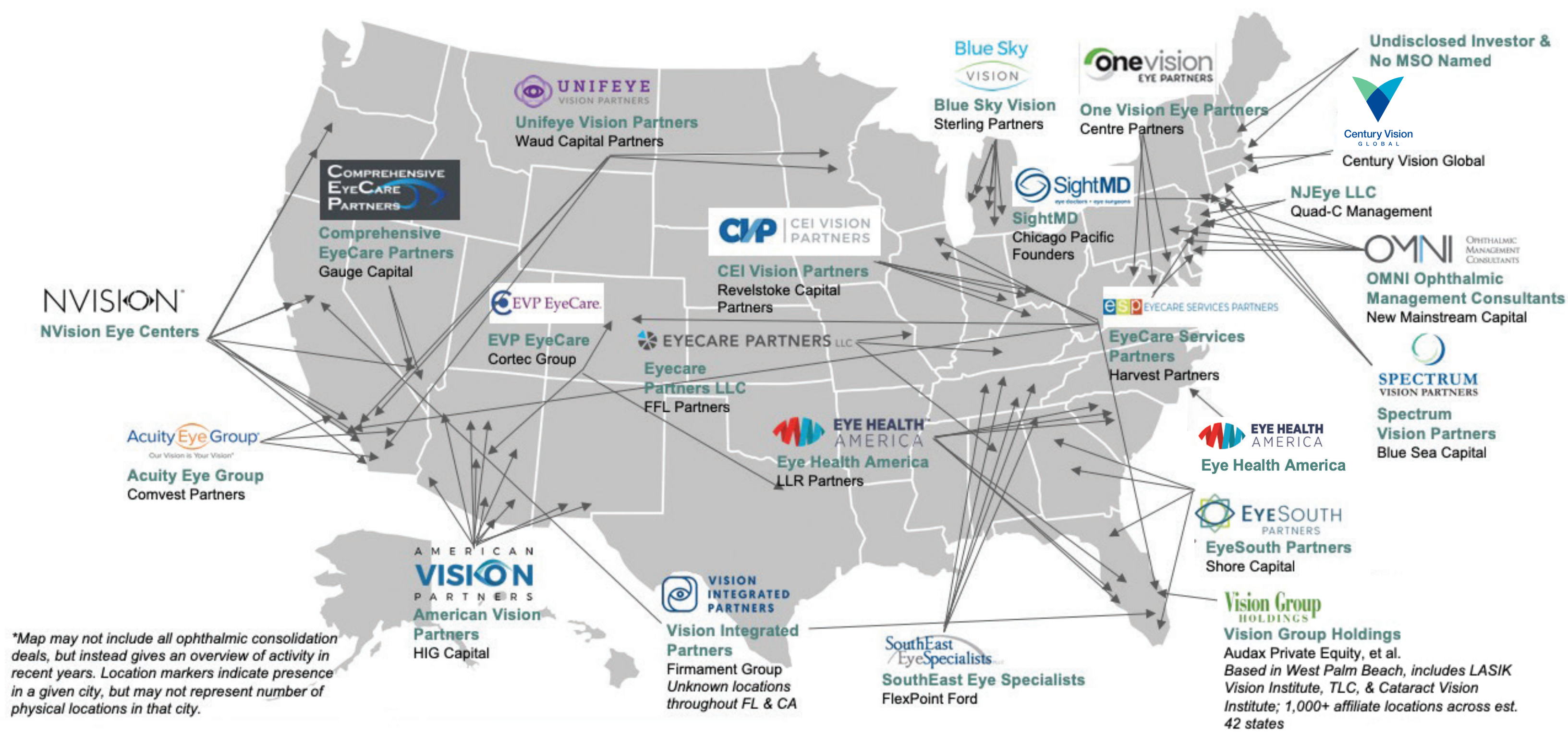

*Map may not include all ophthalmic consolidation deals, but instead gives an overview of activity in recent years. Location markers indicate presence in a given city, but may not represent number of physical locations in that city.

Leaders from all sides of a private equity deal provide valuable insights and factors to consider before signing a deal.

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ANATOMY OF A DEAL

BY MATT OWENS, ESQ., AND NAOMI HARTMAN, ESQ.

During the Private Equity Live Symposium, we provided an overview of private equity (PE) transactions in the eye care space. Most notably, the discussion focused on how these transactions are structured, who the key players are, the stages of a transaction, and the key issues that are presented in these deals.

For various reasons, including prohibitions in some states regarding the corporate practice of medicine, PE firms (and similar financial investors, collectively, "financial partners") will often structure transactions with physician practices through a management services organization or "MSO" model. In this model, an MSO holds the nonclinical assets of the practice and enters into a management agreement with the practice to manage the day-to-day operations. Meanwhile, the practice retains authority over the clinical aspects of the business. In a transaction using the MSO model, if the financial partner does not already have an existing MSO in place, then the physician practice and the new financial partner will form an MSO into which the financial partner then invests. After the transaction, the practice—which at this point is generally referred to as a "captive practice"—remains owned by one or more physicians, while the MSO is generally majority owned by the financial partner, with the former practice owners owning a minority "rollover" interest in the MSO. In some instances, the financial partner's MSO may already have a captive practice that it manages, in which case, a physician practice looking to transact may have all of its clinical assets and operations moved into the existing captive practice.

In any practice management transaction with a financial partner, there are various parties that will be involved:

- **Physician Owners:** The owners of the practice who are looking to transact.
- **Financial Partner:** The PE firm or similar financial investor that is looking to invest in the business of the practice.
- **Investment Bankers:** Financial advisor that assists the physician owners in all stages of the transaction, from the marketing of the practice to finding the right financial partner (as well as maximizing the value of the transaction).
- **Lawyers:** Legal advisors that assist in all stages of the transaction, from ensuring the structure of the deal is tax efficient and compliant from a regulatory perspective, to ensuring that the physician owners protect the value created in the transaction.
- **Accountants/Tax Professionals/ Wealth Managers:** Additional financial advisors that help physician owners with tax structuring and asset protection in connection with these types of transactions.

It is critical that physicians who may be considering a transaction with a new financial partner consult with their advisors early in the process. Advisors will help to guide physicians through the transaction, ensure no key issues slip through the cracks, and minimize missed opportunities throughout the process. Often, these deals are transformational in nature and represent a once-in-a-lifetime opportunity. As with anything this important, selling physicians must have proper advisors in place to ensure value is maximized, assets are protected, and the transaction is structured and consummated in compliance with law.

Most practice management transactions follow similar paths, and include many of the same stages (though no two deals are the same and each can certainly take on a life, and path, of its own):

- **Internal Discussions:** It is absolutely essential before proceeding down this path that all owners of the practice reach consensus on whether they want a transaction and how they see the process unfolding.
- **Hiring of Advisors:** For significant transactions like these, it is always best to engage advisors early in the process.
- **Marketing and NDAs**: Once the practice has decided to pursue a transaction (and often after the practice has hired an investment bank), the practice will begin the process of marketing itself to potential financial partners. These partners will sign nondisclosure agreements and then receive access to financial information and other key items of information about the practice to decide if they wish to pursue a transaction.
- **Initial Due Diligence ("The Dating Stage"):** A subset of financial partners that received initial information will seek additional information about the practice and may want to meet with management and the physician owners to get a better feel for the business. This is not only a time for financial partners to do initial due diligence on the practice, but also an opportunity for the practice to do its own due diligence on the potential financial partners.

STAGES OF A DEAL

- Internal Discussions and Hiring Advisors
- Marketing and NDAs
- Initial Due Diligence/The Dating Stage
- Letter of Intent
- More Extensive Due Diligence and QofE
- Agreement Negotiations
- Closing/Transition

- **Letter of Intent:** Eventually, the practice will likely sign a letter of intent with its preferred financial partner, signaling its willingness to negotiate exclusively with that one financial partner for some period of time as the parties work to get a deal completed based on high level terms set out in the letter of intent.
- **Continued Due Diligence/Quality of Earnings:** The preferred financial partner will then conduct more extensive legal and financial due diligence on the practice and will most likely want to perform its own "Quality of Earnings" review to ensure the valuation agreed to in the letter of intent is supportable.
- **Agreement Negotiations:** All parties, with the help of legal counsel, will negotiate the key transaction documents, which generally will include, at a minimum, a purchase agreement, employment agreements for the selling physicians, and agreements related to the terms and conditions of the rollover equity that will be received by the selling physicians.
- **Closing/Transition:** After all documents have been fully negotiated and all issues resolved, the parties will close the transaction, wire funds, and start working together on the new partnership.

Throughout these stages of a transaction, there are several key issues that selling physicians need to navigate:

- **Valuation:** Valuation is often the first—and most important—issue that physicians focus on. If there are multiple owners, as noted above, it is important they reach consensus at the outset on what the minimum valuation is that all physicians require before transacting. Part of the valuation analysis includes determining how much annual post-closing compensation each physician owner will want (because the more post-closing compensation an owner wants to retain, the lower the upfront valuation will be).
- **Tax Structure:** Physician owners must be sure not to look at valuation in a vacuum—it is just as important to determine how the physician's sale proceeds from the transaction will be taxed. The goal is to structure the transaction as tax efficiently as possible (eg, capital gains instead of ordinary income). The tax outcome will be impacted by the existing legal structure of the practice, how the transaction is structured, and how the rollover equity will be issued, among other issues. Tax needs to be front of mind from the outset, as it can have significant implications on the transaction.
- **Rollover Equity:** Closely related to valuation, because rollover equity frequently represents a large portion of the overall sale proceeds received by the selling physician, are the terms and conditions of the rollover equity (eg, the equity in the MSO that selling physicians will receive as part of the transaction). It is not just a question of what percent of the sale proceeds will be payable in equity, but also a question of what the terms will be of that equity. Two significant questions to get answered at the outset of a transaction are: (1) will the equity received by the selling physicians be the same class of equity held by the financial partner (in terms of economics, etc.), or will the financial partner have a senior, or

preferred, security; and (2) what governance rights will the selling physicians have in the MSO in which they own rollover equity.

- **Noncompetes:** The financial partner will require that all selling physicians enter into noncompetition and related restrictive covenants. This will likely include, at a minimum, a sale of business noncompete for a period of years following the closing, as well as a new employment noncompete that lasts for the period of employment plus some tail period (depending on state laws with respect to physician noncompetes). Selling physicians should determine how important this issue will be to them before getting too far down the road with a transaction.
- **Employment Agreements:** Generally, the selling physicians will be required to enter into new employment agreements with the captive practice. For some selling physicians, this may be the first time they have had to negotiate the terms of their employment. Employment agreements will raise several important issues, including whether a specific work schedule will be required, whether certain outside activities will be permitted (hospital call, expert witness work, etc.), how compensation will be measured and calculated, and the terms of restrictive covenants, among other issues.
- **Associate Physicians:** Frequently, practices that are pursuing a transaction with a new financial partner must address how to treat an associate physician who may be up for partnership (or already in the middle of the partnership buy-in process). This is a delicate issue, and one that requires careful thought and consideration as the practice balances doing what is right by the associate physician and the existing physician owners who may have been partners for many years.
- **Real Estate:** To the extent physician owners also own some of the real estate that is leased and used by the practice, the financial partner may require negotiation of a new lease (as they rarely look to acquire the actual real estate). Not only must the leases be on fair market terms, but physician owners will need to ensure that certain terms of the leases that are important to them as landlord (length of term, triple net, etc.) are not materially changed.

There continues to be significant interest in practice management transactions, and many practices in the eye care space are pursuing (or have pursued) transactions with financial partners. The summary above is just that—only a high-level summary of the some of the many issues and aspects of these transactions. These are complicated transactions, but when done right, they can lead to successful partnerships and exciting opportunities for physician owners.