Private Equity

March 2020 Update

Frost Brown Todd LLC
ATTORNEYS

frostbrowntodd.com

Table of Contents

Private Equity Investment in Oil and Gas through DrillCo Transactions

By Michael Brewster

As a result of tighter capital markets, traditional financing for upstream oil and gas operations, such as drilling, is increasingly difficult to obtain. Borrowers face increasingly stringent lending standards, and lenders are ever cognizant of the inherent risk of upstream oil and gas development, especially in a low-price environment. Upstream oil and gas operators often need to employ alternative financing vehicles, which can be advantageous.

During the last few years, a transaction structure called a "DrillCo" has emerged, which is a term used to describe a drilling joint venture arrangement. In a DrillCo transaction, an investor agrees to fund all or a significant portion of the drilling costs for a certain number of wells in exchange for a percentage interest in the oil and gas lease or the well, which is called a working interest. The drilling costs that the working interest owner funds include a portion of the costs associated with the exploration, drilling and production of a well.

In a DrillCo transaction, an operator contributes acreage, and the private equity investor contributes cash to cover most of or all the costs associated with drilling oil wells. In exchange for putting up the capital, the investor earns and is assigned a working interest in the wells drilled. In typical DrillCo transactions, the working interest assigned to the investor is subject to partial reversion to the operator once the investor achieves a predetermined internal rate of return on its investment, called an IRR Hurdle.

Operators like the use of DrillCo arrangements because, if structured properly, DrillCos preserve cash flow and avoid balance sheet liabilities. For an operator with limited access to capital that is holding acreage with development potential, a DrillCo transaction presents an attractive mechanism by which the operator can develop its acreage. Instead of using its own cash, an operator relies on the investor's funds to increase production and enhance the value of the acreage. Utilizing this strategy, the operator is more likely to obtain favorable terms in an ultimate sale, a public offering or a refinancing. In addition, a DrillCo enables drilling activities to commence, which can also provide the operator with the capital necessary to maintain its leases prior to the expiration of the primary term.

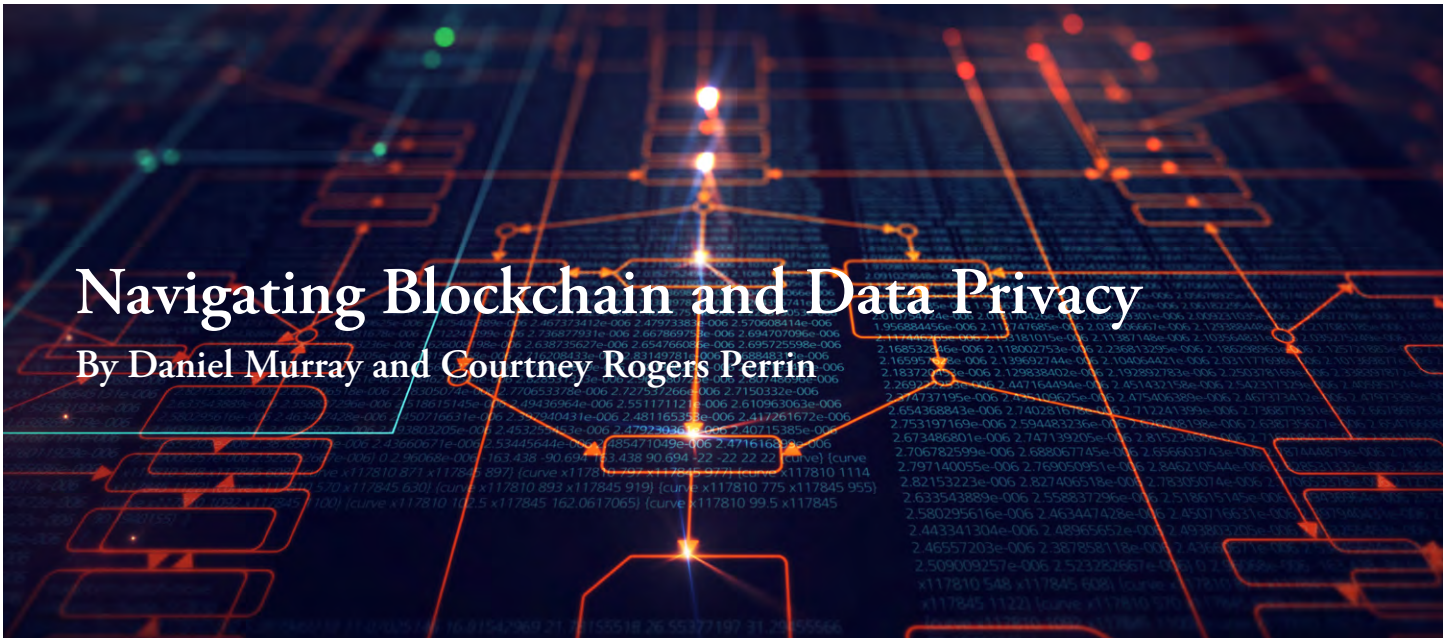
Private equity groups favor DrillCo arrangements for a variety of reasons. First, a DrillCo allows the private equity group to invest a substantial amount of capital in a single transaction while utilizing an efficient and effective means of investing. With a DrillCo transaction, the investor looks for an established operator with a proven acreage position, a track record of success and well production, which minimizes the investment risk. The investor can minimize the geological and operational risks by investing in drilling prospects that have been identified, tested, and proven. Finally, investors prefer DrillCo arrangements because they offer greater protection in the event of a bankruptcy, because the investor owns a real property interest in the assets through the assignment that it receives.

A DrillCo is typically used in areas where the geological formations have proven to be productive and where the geology has been developed. Because of the prior production and the tested geology, there is a reduced risk profile associated with development. For the operator, an area like this creates many possible drilling locations that will likely produce reliable cash flow. However, the operator may not have the capital to develop all of these possible locations. As a result, areas like this are attractive to both operators and investors, with the downside being that a large amount of capital is required to develop this inventory of drilling locations.

CONTACT THE AUTHOR

For a more in-depth discussion regarding DrillCo transactions, contact Mike Brewster of Frost Brown Todd's Private Equity Industry team.

Mike Brewster
Managing Associate | Pittsburgh
412.513.4322
mbrewster@fbtlaw.com



Navigating Blockchain and Data Privacy

By Daniel Murray and Courtney Rogers Perrin

Blockchains are becoming more prominent in cryptocurrencies like Bitcoin, supply chain applications, and more. Two typical features of blockchains are transparency and immutability.

Despite the money flowing into this technology, there are several legal challenges, including the application of data privacy laws. Here are some issues to keep in mind.

Who has jurisdiction?

There are no clear borders when it comes to data privacy or blockchain. Data privacy laws can cover a state (California Consumer Privacy Act) or a group of countries (General Data Protection Regulation "GDPR" in the European Union). And these laws often apply to a subject citizen, regardless of that citizen's physical location. Meanwhile, public (or distributed) blockchains may reside on computers scattered around the world. Private blockchains may reside at a centralized location. But even then, if multiple countries can use that private blockchain, then each country's data privacy laws may apply.

Courts have just begun to address the jurisdictional issues. In the United States, courts are looking at previous case law on websites. Although it's difficult, best practice would be to comply with each local law applicable to your blockchain, including server location, consumer citizenship, and consumer location. To avoid a specific data privacy law, blockchains will likely have to prohibit users and servers from that locale. This could mean blocking all U.S. IP addresses, for example.

Right to "Delete"

Data privacy laws sometimes provide consumers a right to delete data. This poses a challenging feat when the data may reside on millions of computers around the world, the blockchain may have no managing central authority, and it may have been built to be immutable. Helpfully, pseudonymization of the data can reduce some of the compliance requirements associated with deletion. Under pseudonymization, a piece of data can only identify a consumer when combined with additional data.

Controllers v. Processors

Data privacy laws often distinguish parties that collect and control data from parties that simply hold the data temporarily to complete some analysis. In the land of blockchain, the blockchain itself—particularly if it's a private blockchain—is likely the controller. That raises the compliance requirements.

Right to Transfer

Like the right to delete, a right to transfer implies that consumers can control their data and move it at will. But in blockchain this may not be possible. Again, as with the right to delete, blockchains will want to implement data pseudonymization to avoid the most onerous requirements of data privacy laws.

Chief Compliance Officer – CCO

GDPR requires companies to name a chief compliance officer in some cases. But even if GDPR is not applicable, most companies will need a specialist to monitor its data privacy activities and possible compliance issues. Because data subjects often reside in multiple countries, companies can quickly become subject to multiple data privacy laws. With or without a data protection officer, blockchains should document their efforts to comply with GDPR and other laws.

Data Privacy Concerns in Private Equity

By Craig Cox and Daniel Murray

Privacy, data security and data ownership issues are increasingly relevant for buyers in M&A transactions. This may result from the industry involved, the importance of data as a company asset, the use of data in the company's marketing and sales, or because the company's operations involve regulated data. Applicable laws include GDPR in Europe, CCPA for California, HIPAA for the United States, and PIPEDA for Canada.

Data issues should be a primary concern for buyers, both when conducting due diligence into a target company and when documenting the sale with appropriate representations and warranties and indemnity provisions. Failure to properly address these issues in an acquisition could subject the buyer to private causes of action from customers and other individuals and to action from regulators.

Due Diligence Concerns

Disclosure requests should address several key areas. Buyers need to understand a target's treatment of regulated data such as health data, financial data, customer personal data, and data related to minors. Buyers should learn how companies interact with both customers and vendors.

Contracts with Data Subjects

Buyers need to understand a company's privacy policies and contractual obligations related to customers. What kind of consent has been obtained from customers? Does the consent cover the types of activities that the buyer will engage in? The results of these analyses may impact the valuation of any deal. Remember, even if customer data isn't at issue, data privacy laws may apply to employee data.

Post-acquisition, buyers may need to provide notification to, or obtain additional consents from, data subjects. Note what laws apply and what further consent is needed. If the acquisition is confidential, consent from customers will have to wait until the deal is completed.

Contracts with Vendors

Also relevant are contracts with suppliers that may collect or store data on behalf of the company, as well as any contracts the company may have to collect, process or store customer data for. Buyers should investigate a target's security procedures and history of breaches. Does the company use third parties to perform security or vulnerability assessments or data audits? How does the company manage its network and data? Remember that one vendor is the data room provider. The parties will want to ensure that the data room provider complies with applicable law. Certain data may need to be protected from disclosure during the acquisition process. Pseudonymization or anonymization of personal data may be necessary.

Reps & Warranties

Representations and warranties can determine the target's compliance and track record under applicable laws. This includes having the target confirm that they have established policies to comply with applicable data privacy and security laws and best practices. Also, confirm any security breaches, audits, or governmental investigations relating to data privacy and security that involve the target. Buyers should require the target to identify every jurisdiction for which the target possesses protected data.

Indemnification

Do your best to apportion risk of data privacy non-compliance. However, some laws, such as GDPR, may limit the extent to which apportionment can remove risk to either party. Seek appropriate insurance coverage when possible.

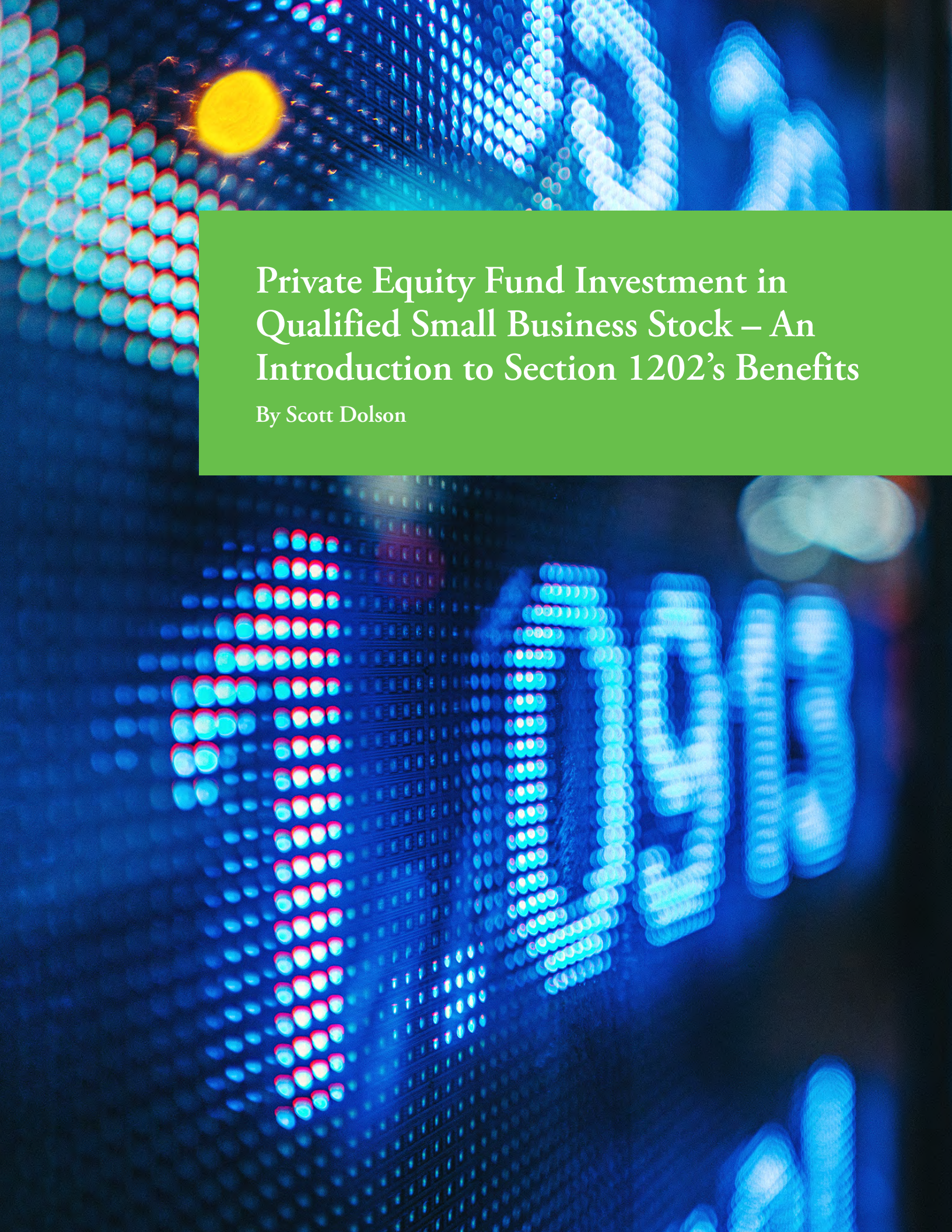
CONTACT THE AUTHORS

For a more in-depth discussion regarding the blockchain and data privacy, contact Craig Cox, Daniel Murray, or Courtney Rogers Perrin of Frost Brown Todd's Private Equity Industry team.

Craig Cox
Member | Dallas
214.580.5855
ccox@fbtlaw.com

Daniel Murray
Managing Associate | Dallas
214.580.5853
dmurray@fbtlaw.com

Courtney Rogers Perrin
Managing Associate | Nashville
615.251.5592
crogersperrin@fbtlaw.com



Private Equity Fund Investment in Qualified Small Business Stock – An Introduction to Section 1202's Benefits

By Scott Dolson

Section 1202 of the Internal Revenue Code provides for a potential exclusion from federal income tax of 100% of gain from the sale of qualified small business stock (QSBS), including alternative minimum tax, the 3.8% net investment income tax and often state income taxes. If a private equity group's (PEG) fund with 20 owners acquires QSBS of XYZ Corp, **each** of the 20 owners has a potential gain exclusion from the sale of the QSBS of at least $10 million.

QSBS can only be issued by a C corporation. This fact used to be a major reason why Section 1202 was ignored by many advisors since its enactment in 1993. But with corporate tax rate reduced from 35% to 21%, operating as a C corporation has become more attractive, particularly when the rate reduction is combined with Section 1202's benefits.

While some venture capitalists have structured their investments to take advantage of Section 1202, its potential has not been fully explored by many PEGs. Under the right circumstances, Section 1202 can deliver dramatic tax savings for a PEG's investors.

The PEG business model of buying and selling businesses makes PEG investments natural candidates for including the issuance of QSBS in the transaction structure. The difficult task is molding a traditional leveraged buy-out (LBO) transaction into a structure that permits both an investment by the PEG fund in QSBS and a tax-free rollover of target company equity by the management team. The holding period requirement may exclude some PEG investments from Section 1202 planning, but the holding period for at least some PEG and family office investments exceeds five years.

A critical point from a planning standpoint is that Section 1202 doesn't limit its scope to investment in corporations engaged in *de novo* start-up activities. There is nothing in the language of Section 1202 that restricts an issuer of QSBS from acquiring equity or assets of a qualified small business. This interpretation of Section 1202 opens the door to investment in QSBS by PEGs in connection with their M&A investment activities.

An issuer of QSBS to a PEG could be a corporation organized to roll up assets or equity of a target company, or it could be the equivalent of a "blocker corporation" organized to hold an equity interest in a target company. The target company itself might be a pass-thru entity such as an LLC (taxed as a partnership) or a greater than 50% owned corporate subsidiary. With careful attention to Section 1202's workings, it should be possible in most cases to structure an acquisition that accomplishes both the issuance of QSBS (including avoiding the redemption issue) to the PEG and the tax-free rollover of target company equity or assets by target management.

Where a target company would cause the corporation issuing QSBS to fail Section 1202's $50 million size of issuing corporation limitation, possible solutions might include first forming a C corporation to issue QSBS to the PEG, followed later by the corporation's acquisition of target company assets or equity, or the formation of two or more corporations issuing QSBS and acquiring assets or equity of the target company.

In spite of the potential for extraordinary tax savings, many otherwise experienced tax advisors are unfamiliar with the innerworkings of Section 1202. Given the challenges associated with structuring investments in QSBS and documenting Section 1202 eligibility, we recommend that PEGs identify tax advisors who have extensive experience working specifically with Sections 1202 and 1045.

CONTACT THE AUTHOR

For more information, contact Scott Dolson of Frost Brown Todd's Private Equity Industry team.

Scott Dolson
Member | Louisville
502.568.0203
sdolson@fbtlaw.com

SURPRISE! You may be liable for union pension plan withdrawal liability.

By Michael Bindner

When a participating employer stops contributing to, or no longer has an obligation under a collective bargaining agreement (CBA) to contribute to, an underfunded multiemployer (union) pension plan, the employer may be liable for "withdrawal liability" even though it always paid its required annual contributions to the pension plan. Withdrawal liability can be triggered when an employer has a significant union workforce reduction (a partial withdrawal), a complete union workforce reduction (a complete withdrawal), or a withdrawal of all employers from the pension plan (a mass withdrawal).

The employer is primarily responsible for paying the withdrawal liability, but other businesses which have common ownership with the employer will also be liable. Shareholders of an incorporated business, partners in a partnership, or an alter ego or successor business may also be responsible for withdrawal liability if the participating employer does not pay the withdrawal liability to the pension plan.

The following is an explanation of the potential liability of certain entities, other than the employer, when the participating employer becomes insolvent and can't pay the withdrawal liability.

Liability of Commonly Owned Businesses

All entities which are considered under common control (i.e., a parent-subsidiary group or a brother-sister group), as determined by Internal Revenue Service regulations, are jointly and severally liable for the withdrawal liability if the participating employer does not pay the liability.

Successor Employer Liability

A purchaser of assets generally does not acquire a seller's liabilities, but some federal courts have found a buyer of assets liable for the seller's withdrawal liability as a successor business. Successor businesses to entities which are assessed withdrawal liability have been found liable for unpaid withdrawal liability if they:

- had notice of the liability and
- continued the business of the predecessor entity (typically referred to as a "continuity of operations") after purchasing the assets of such entity.

Liability of Private Equity Investors

A private equity fund that is under common control with an operating entity (sometimes referred to as a "portfolio company") can be responsible for withdrawal liability that is originally assessed to the operating entity if the private equity fund's involvement in the operating entity is sufficiently active as to render the private equity fund a "trade or business" (i.e., not a passive investor).

In the *Sun Capital Partners* cases, federal courts determined that two Sun Capital funds were not merely "passive investors," but "trades or businesses" because they operated and managed the operating entity and were provided a direct economic benefit that an ordinary passive investor would not derive. The courts applied what is referred to as the "investment plus" test (i.e., the owner is more than just a passive investor) in making the determination that the Sun Capital funds were "trades or businesses." Fortunately for the funds, the U.S. First Circuit Court of Appeals, in a decision issued in November, 2019, held that because (1) neither Sun Capital fund owned at least 80% of the operating entity and (2) the two funds were determined not to be in an implied partnership with each other, the two funds were not considered in common control with the operating entity and thus not responsible for the operating entity's withdrawal liability.

CONTACT THE AUTHOR

For a more information contact Michael Bindner of Frost Brown Todd's Private Equity Industry team.

Michael Bindner
Counsel | Indianapolis
317.237.3863
mbindner@fbtlaw.com

Credit Financing: Adjusted EBITDA Cheat Sheet

By Aaron Turner

In its simplest form, Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) forms the basis for some type of leverage ratio financial covenant, and those covenant levels are derived from the operating entity's historical financial information as well as the projections provided by the private equity sponsor, borrower, financial advisor or similar representative. EBITDA serves many other functions as well in these types of facilities—for example, in loan pricing and incurrence-based restrictive covenant exceptions.

The negotiation by borrowers and lenders concerning the definition of EBITDA in cash flow-based credit facilities is fundamental to the size of the default risk of the applicable loan. Sponsors and borrowers, certainly, and even lenders, in many cases, have some interest in mitigating loan default risk by creating a leverage calculation that is a market-accepted approximation of the borrower's consistent operating cash flows. In addition, especially for highly leveraged deals, regulated lenders have an interest in creating a thoughtful definition of EBITDA that, within such lender's underwriting and risk policies, avoids unnecessarily painting an overly leveraged picture of the lender's loan portfolio and other consequences of regulatory "red flag" loans.

This article is a brief reminder (for all market participants to consider when negotiating the EBITDA definition in credit facilities) of the general types of EBITDA add-backs that are often included in middle-market, cashflow-based credit facilities, particularly those with private equity sponsor influence. The general objective of credit facility EBITDA is to add back to net income the interest, taxes, depreciation and amortization, as well as to addback certain other non-cash, extraordinary and transaction-related items deducted from earnings when determining net income.

Negotiation of EBITDA add-backs often include discussions around the following add-back types:

- Losses from interest rate hedging agreements.
- Financing fees and other amounts arising in connection with incurring indebtedness.
- Restructuring charges and projected savings/synergies in connection with a restructuring.
- Management and advisory fees and indemnities and expenses under sponsor management agreements.
- Other extraordinary, nonrecurring or unusual losses or expenses (e.g., arising from transactions, integrations, transitions, facility opening, consolidation, relocation and expansion costs).
- Costs of employee benefit plans or management and board stock option plans, to the extent such plans are funded with contributed capital or equity proceeds.
- Cash receipts in respect of previously excluded non-cash gains.
- Losses on sales of securitization assets.
- The excess of GAAP rent expense over cash rent expense.
- Fees, costs and expenses arising in connection with a transaction permitted by the financing documentation.
- Proceeds of business interruption insurance for the applicable period.
- Litigation expenses.
- All other non-cash charges.
- Add-backs included in the borrower's projections.

Each of these add-back types (and many others not listed) have their own nuances and level of market acceptance to consider. EBITDA is only one definition in agreements that are often in excess of 150 pages of highly complex terms and provisions, and both lender and borrower/sponsor sides rely on strong representation from outside counsel to navigate credit documentation.

CONTACT THE AUTHOR

For a more in-depth discussion regarding the merits of different EBITDA-related contract provisions, contact Aaron Turner of Frost Brown Todd's Private Equity Industry team.

Aaron Turner
Member | Dallas
214.580.5858
aturner@fbtlaw.com

Introduction to Private Equity's Acquisition of Medical Groups

By Brian Higgins and Tom Anthony

Private equity's expansion into healthcare has proliferated in the past decade, with over 181 private equity deals for all types of physician practices in 2018 alone, according to a Modern Healthcare. Most recently, private equity firms have been interested in investing in specialty practices like orthopedic, gastroenterology and urology practices. These private equity firms buy in for a quick return on investment, typically selling their stake in the medical group within 3-5 years, most often to another private equity firm. Medical groups may find these deals attractive because it is both lucrative for the physicians and also can allow them to focus more on patient care and keep costs down for their patients and practice. While private equity acquisitions of medical groups can result in positives for private equity firms and medical groups, the upfront structuring of these private equity deals with medical groups involves careful planning to avoid the risks posed by a variety of legal concerns.

For example, many states prohibit the "corporate practice of medicine," which effectively means that the only owners of a medical group can be state-licensed physicians. Further, many states also prohibit physicians from splitting the fees generated from their medical services with others. Generally, these prohibitions arose to protect patients from individuals or companies that are not licensed physicians from making medical decisions which may be influenced by making a profit at the expense of patients' best healthcare interests.

These types of prohibitions make it very difficult for a private equity firm to buy-in directly to a medical group. Thus, private equity firms interested in the healthcare space need to find a different vehicle by which to generate revenue from a medical group. This vehicle is typically a management services organization (the "MSO"), which is a separate legal entity created by the private equity firm to own and manage all the non-medical or business aspects of the medical group. To generate revenue for the MSO, the medical group's assets—chairs, medical equipment, gauze—are sold to the MSO and then leased back to the medical group for a fee. In addition to this leaseback arrangement of hard assets, the MSO may provide management services to the medical group for a fee. These management services usually consist of the back-office functions of the medical group, like billing and collections matters, office administration, and information technology services. The leaseback of the assets and management services provided by the MSO to the medical group are typically embodied in a long-term (sometimes 15-40 years), heavily negotiated management services agreement.

To patients getting care at a medical group that has an arrangement with an MSO, their experience is no different while in the physician's office. If anything, the stakeholders in the arrangement hope the patients' experience has improved. Our law firm has deep experience advising clients on healthcare acquisitions and would be happy to counsel anyone interested in a private equity healthcare deal.

CONTACT THE AUTHORS

Please contact Brian Higgins or Tom Anthony of Frost Brown Todd's Private Equity Industry team for more information.

Brian Higgins
Senior Associate
Cincinnati
513.651.6839
bhiggins@fbtlaw.com

Tom Anthony
Member
Cincinnati
513.651.6191
tanthony@fbtlaw.com

About Frost Brown Todd

A full-service law firm with more than 525 attorneys in multiple states, Frost Brown Todd offers that rare blend of local market knowledge and world-class problem solving. Our attorneys work together across disciplines and across the map to support a diverse client base, including some of the world's best-known companies as well as numerous startups, government entities, and social-sector organizations. Whether we're crafting deals or compliance solutions that are above reproach, or intervening in high-stakes commercial disputes, we're driven to exceed expectations and deliver value by working creatively, meticulously and passionately.

Industry-Focused Services

There is no substitute for deep industry knowledge and experience. Our industry teams have both in abundance.

Each team has been organized comprehensively to ensure consistent and effective execution across our clients' broad range of legal needs. With a focused understanding of both the everyday realities and changing dynamics of the industries we serve, we're able to protect and assist our clients at the most essential levels, from the C-suite to the factory floor, from the high courts to the data room, and everywhere in between.

Our Culture

We strongly believe that diversity enriches the creativity of our team, which in turn leads to better solutions for our clients.

We also believe that an inclusive workplace is the cornerstone of a healthy business. Our formalized diversity and inclusion efforts feature an ever-growing mentor program, a corporate culture of acceptance, a commitment to work-life integration, and an energized Women's Initiative — all contributing to a more vibrant law firm for our people, our clients, and communities.

INDIANA
Indianapolis

KENTUCKY
Florence
Lexington
Louisville

MICHIGAN
Ann Arbor

OHIO
Cincinnati
Columbus
West Chester

13 MARKETS ACROSS 9 STATES

PENNSYLVANIA
Pittsburgh

TENNESSEE
Nashville

TEXAS
Dallas

VIRGINIA
Richmond

WEST VIRGINIA
Charleston

INDUSTRIES

Energy
Financial Services
Franchise & Hospitality
Health Care Innovation
Manufacturing
Mobility & Transportation
Private Equity
Technology

PRACTICES

Bankruptcy & Restructuring
Business & Commercial Litigation
CMBS Lending & Servicing
Construction
Corporate Law
Employee Benefits & ERISA
Environmental
Estate Planning & Administration
Financial Transactions
Government Services
Insurance Regulation
Intellectual Property
International Services
Labor & Employment
Litigation
Product Liability & Mass Tort
Real Estate
Tax

Frost Brown Todd LLC
ATTORNEYS

frostbrowntodd.com

frostbrowntodd.com

Indiana | Kentucky | Michigan | Ohio | Pennsylvania | Tennessee | Texas | Virginia | West Virginia