# Mergers & Acquisitions
# Transactions in the Health and Social Care Sector

## 1. Introduction

Whilst the health and social care (**HSC**) market faces widespread underfunding, shortages in committed and experienced staffing, regulatory pressures and often less than positive media attention, the news in the sector is not all doom and gloom. Mr Hammond has announced modest additional funding and there is a much greater recognition of the importance of nursing, care and support services, even if only to alleviate pressures on the NHS.

One factor that is not in dispute is the ever growing increase in demand in the sector and it is hardly surprising that the market continues to grow; new developments continue apace. The Competition and Markets Authority valued the UK care homes sector at around £15.9 billion last year and CBRE estimated some £13.5 billion of equity being invested in healthcare real estate in 2018, together with a more flexible approach being adopted by institutional investors.

Given increases in demand, positive indicators in relation to debt (as well as equity) finance and the fact that many providers cannot viably continue to run at current scales (some 80% of providers run just one care home for example), there is inevitably a continued appetite for mergers and acquisitions. This guidance note and accompanying documents is focused on this area of market activity.

What follows is in no way a substitute for seeking appropriate professional advice, the importance of which members will recognise. In addition the template documentation provided are intended to form a starting point for discussion and should not be relied on as definitive.

Many Care England members will already be active in the M&A sphere and some of what follows will seem rudimentary to those organisations, but we hope that there will be something useful even for the seasoned transactional hand.

### 2.2 Asset or share purchase?

From a legal, financing and accounting perspective the defining feature of a transaction will be whether an asset or share purchase is involved. There will be various factors which dictate which model is preferable, but generally speaking investors (the **Buyer**) will prefer an asset sale because it is a *cleaner* transaction in terms of where liabilities lie and often easier to fit within existing business structures.

**Sellers** tend to favour share sales, mainly because there are significant tax advantages for vendors. Where the Seller is willing to adopt the asset sale model, there will sometimes be an expectation of a higher price to reflect the benefits the Seller is foregoing. In any event, the trend in the market (if not the HSC sector) is for disposals by way of shares.

Some of the principle differences and implications for the Buyer and Seller are summarised below. This is by no means an exhaustive or comprehensive list and we would strongly recommend that you seek specialist advice, particularly in relation to the tax aspects of any transaction (upon which Hewitsons do not advise), which will often be the decisive driver to the model adopted and the range of acceptable pricing:

***Asset Sale***:

- *Cherry picking* – the Buyer has the ability to choose which assets and/or liabilities to acquire (rather than everything transferring). The Seller potentially has the advantage of retaining certain assets (which in a share sale would have to be transferred out of the company prior to the sale), particularly where it considers that the Buyer has undervalued these. The Seller may also, however be left with unwanted liabilities.
- *Restrictions on transfer* – some assets simply cannot be transferred (some licences; permits; reseller and social media accounts; legacies and other assets subject to trusts) and would only be accessible if a share sale is adopted.
- *Employees* – TUPE will almost always apply to an asset sale and the Buyer will have no choice but to take on employees on the terms previously enjoyed. In the HSC sector this can be extremely expensive, especially around pension liabilities.
- *Boardroom approval* – usually a sale of assets will been viewed as a function of management and will not require the same approval (from the Board and/or shareholders) as for a share sale.
- *Leases/Contracts* – there will often be requirements in leases and other contracts that prevent assignment without the prior consent of the landlord or other party. Obtaining these consents in an asset purchase can be timely and consume extensive management or external resources. Ultimately a failure to obtain the relevant consents may enable the other party to terminate or rescind the contract.
- *Due diligence/legal input* – generally (although by no means guaranteed) the level of due diligence required and resources required for negotiations on warranties etc. will be less for an asset sale than in the case of a transaction involving the acquisition of shares.

- *Tax/balance sheet*:
  - Where all of the assets are transferred, the sale is usually classified as being of "*a going concern*", and Value Added Tax will not be payable on the transaction.
  - The Buyer may be able to reset the market value of the assets to be that at the time of the purchase and this will typically reduce the Capital Gains Tax ("CGT") payable by the Buyer in the future.
  - Where assets are sold at a loss, the Seller should be able to off-set profits or other chargeable gains made elsewhere.
  - In an asset sale, the Buyer may allocate different values for different assets (i.e. carve up the consolidated price paid when entering these separate items onto the company's books). Higher prices can therefore be set for assets for which the Buyer can claim depreciation.

***Share Sale***:

- *All or nothing* – as the Buyer effectively steps into the shoes of the Seller, it acquires everything. This means there is usually no need for third party consents (unless there are change of control provisions) and leases, contracts and all other relationships transfer automatically. This should include intangible items such as commissioner, supplier and customer relationships.
- *Liabilities* – the downside for the Buyer to the above is that there may be *hidden* liabilities within the company which do not appear as part of the due diligence process, are not covered by warranties, fall outside the warranty period or exceed the value shown on the balance sheet.
- *Approvals* – again there are likely to be far less regulatory or other third party approvals in a share purchase; something of benefit to both parties. In contrast internal approvals from the Board and/or shareholders are far more common in the case of share sales.
- *Employees* – TUPE will not be triggered as there is no transfer. Whilst some employees (that have transferred from local authorities or the NHS) may have entrenched rights, it should be easier for the Buyer to downsize or change terms. Equally the Buyer will take on any existing disputes or actions being brought by/against employees.
- *Due diligence/legal input* – as above, given the possibility of "*hidden liabilities*" and the fact that everything transfers to the Buyer in a sale purchase, the level of due diligence required and resources required for negotiations on warranties etc. will be greater in the case of a transaction involving the acquisition of shares.
- *Tax/balance sheet:*
  - Where the target is owned by individual Sellers, the sale gives rise to a single charge to CGT. On an asset sale, in contrast, there is a potential double tax charge on an asset sale. The selling company may suffer corporation tax on chargeable gains that arise on the sale of the assets. Additionally, the shareholders in the selling company may then suffer income tax on dividends paid out of any profit that is made from the sale of the assets.
  - Provided the Seller meets certain criteria (officer/employee of company for set period prior to the disposal; minimum shareholding), the Seller should benefit from Entrepreneur's Relief.

- There is also a potential benefit to a vendor company under the Substantial Shareholder Exemption where it holds at least 10% of the ordinary share capital of the company invested in, the shareholding is held for a continuous 12 month period in a prescribed period prior to the disposal and certain other conditions around the distribution of profits and assets on a liquidation are met.
- The Seller may acquire additional tax advantages where it takes all (or part) of the payment in shares or loan notes of the Buyer's company. Tax on the gain may be deferred in such cases until the consideration shares or loan notes are sold.
- In some circumstances, the Buyer may be able to enjoy tax benefits, usually where there have been accumulated losses in the business which can be written off against future profits.
- Stamp duty will be payable on the acquisition of shares, but where a transaction involves a large amount of property a share sale will often attract less overall duty. This is because the SDLT (Stamp Duty Land Tax) on the property portfolio at 4% (applicable to an asset sale) is likely to exceed the 0.5% stamp duty on the share transfer.

**2.2 Financing**

In some circumstances the Buyer may be able to use existing cash reserves, but this is the exception rather than the rule. The main sources of funding for the transaction will usually be either (or a combination) of debt or equity finance, with CBRE reporting that studies indicate that the former is taking on a renewed role as a funding source in the sector.

Within these broad categories there are numerous methods of raising finance:

- **Debt Finance** - straightforward loans, debt securities such as bond issues, syndicated loans, subordination, mezzanine or other layered debt financing;
- **Equity Finance** - rights issues, open offers, bought deals, cash box or vendor placings.

The intricacies of these funding options is outside the scope of this guidance, but it is worth setting out some of the considerations which may influence a Buyer in choosing which financing arrangement to enter into:

- *Comparative cost* -
  - Debt finance: Calculating the cost of debt finance is easier to establish compared to determining the cost of equity funding. The main factor will simply be the interest rate at and other terms on which the Buyer can borrow. The tax system is also seen to favour borrowing because generally interest (unlike dividends) is tax deductible from profits and when assessing the cost of borrowing, account can be taken of these tax savings.
  - Equity finance: This is often a complex calculation based on (i) the anticipated return to shareholders (through dividends, capital appreciation and share buybacks), (ii) the cost to existing shareholders because their share of the future dividends and capital growth is diluted, (iii) the relative return of those shares against so called "*risk free*" assets such as gilts and other long term securities and (iv) the company's weighting.

- *Gearing* – if the Buyer's gearing (ratio between borrowing and equity), is too high, it may simply not be able to secure debt finance and equity will be the only option.
- *Restrictions on borrowing* – there may be limits on the amount the Buyer can borrow either because of its Articles of Association or the terms of existing debt instruments of loan agreements. Even if additional borrowing is permitted it is likely to be subject to the consent of any current lender(s) and may result in a renegotiation of the terms the Buyer is subject to. In these cases, equity is likely to be the most viable means of raising funds.
- *How the Buyer's shares are rated* – where the shares are highly rated by the market, it may be in the interest of both the Buyer and Seller to finance an acquisition through equity finance.
- *Impact on post-acquisition earnings* – a low interest rate will obviously make debt finance more attractive, but highly rated shares may mean an issue of equity will be more likely to enhance earnings. Broadly where the price/earnings ratio is higher than the ratio of interest costs to borrowing, equity finance will have a healthier impact on earnings per share.
- *Tax implications* - it will come as no surprise that the post-tax consequences of the various financing options will be a key issue in assessing which is the preferred route for the Buyer.

## 3. HSC considerations

In addition to the above more general principles there are a number of issues which are specific to the health and social care arena. We touch below on a few of these:

### 3.1 Care Quality Commission (CQC)

- *Notifications* - as members will already be keenly aware CQC require providers to submit notifications for a wide range of matters. In the context of a sale and purchase (whether by way of share or assets) these could typically involve statutory notifications regarding changes to the registered manager, nominated individual and/or officers or directors. What is not always recognised until too late is the time that it takes for CQC to record and register these changes.

  In the case of an asset sale, the time between submission of the relevant forms and formal acceptance by CQC can be particularly problematic if not taken into account in the transactional timetable. In the worst case scenario, the Seller will remain on the statutory register (and therefore liable) for the registered activity and/or location but the management of this will have transferred to a new provider. There are evident issues about the allocation of liabilities in such a situation, but more worryingly the fact that the organisation is in breach of the Regulations with the potential sanction of being closed down.

  This should be something which can be managed from a practical perspective; allowing 3 months for notifications in the timetable, keeping CQC informed of the transaction and its progress and having some short term indemnity provisions to hand to cover any gap in the responsibilities of the old and new entities.
- *Financial factors* - where a provider is subject to CQC's market oversight regime, is queried over its Statement of Financial Viability or is under any conditions around its financial standing this may not only make the organisation less attractive to potential purchasers but is likely to impact

the model of sale adopted and/or the availability of funding.

### 3.2 Other regulators

- *Ofsted* - similar considerations will apply to those set out above in relation to CQC where educational services are part of a transaction and Ofsted is often stricter in relation to the acceptance and registration of relevant notifications.
- *Homes England* – where the acquisition involves registered or other social housing providers, it may have additional burdens in terms of (i) notification/approval to/from Homes England (formally the Homes and Communities Agency), (ii) sanction from existing lenders, (iii) restrictions in grant funding arrangements and (iv) requirements on the Buyer in relation to the post completion treatment of housing stock and/or tenancies.
- *Charity Commission* - not for profit and charitable organisations are common in the HSC sector and where charities seek to merge, issues will apply in addition to normal transactional considerations. Whilst specialist advice should be sought some key points to watch out for are:
    - Where two charities merge there may need to be changes to the Memorandum and Articles of Association particularly where the objects of the two charities are not closely enough aligned. Some of these changes (objects, dissolution, and benefits to trustees) will require approval by the Charity Commission.
    - Even where formal approval is not required there may be administrative notifications to put in place, for example to be placed on the Commission's Register of Mergers. In any event, it is always prudent to notify the Commission of the new arrangements.
    - Where there is legacy income or entrenched trusts which would end if the original charity effectively ceased to be, this may influence the model of the merger adopted or require the transferring entity to continue to exist in some form at least for a period of time.
    - Where a transaction involves one charity becoming the subsidiary of the other or a group structure, consideration will need to be given to how to ensure sufficient independence of the organisations can be demonstrated to satisfy the Charity Commission. There may even be questions about whether the "parent" charity in these scenarios should have charitable status at all if, for example, its only role is to provide central management and strategic direction for the other entity/ies.
    - Charities will also of course often carry out fund raising activities and the parties to any sort of merger or acquisition will need to be particularly sensitive to the response of existing and future donors and benefactors. This also means that issues around the name and brand under which the post transaction organisation(s) operate can be of particular significance.

### 3.3 Local authorities/NHS bodies

Almost all providers will be engaged with local authorities and/or health bodies. We do not need to tell members how demanding these relationships can be! As in any sale and purchase, due diligence will need to be carried out in relation to contracts that are either transferred (under an

asset sale) or automatically pass (on a share sale) to the Buyer.

This process can be particularly challenging when dealing with contracts with commissioners. To start with there are practical complications in that (i) often providers deal with very large numbers of different local authorities and CCGs and (ii) tracking down the agreements themselves can be problematic or often impossible. This adds a substantial administrative burden on the Seller and potentially unacceptable uncertainty for the Buyer.

From a legal perspective, almost all contracts with public authorities will place constraints on the provider regarding assignment, novation or any other transfer of the agreement (relevant to an asset sale) and also sometimes contain restrictions on change of control (impacting on a share sale). Typically these provisions will allow the relevant dealing, but subject to the consent of the commissioner, without which the transfer could potentially be void. Again there is a cost here in seeking appropriate approvals.

Timing may also be hard to manage. It can take far longer to effect this process than it would be when dealing with a commercial entity and this will need to be factored into the transaction timeframe. Equally the parties will not want to set hares running too early when the disposal is not yet guaranteed and may not even be in the public arena. A final concern is that commissioners in some circumstances may seek to use the transaction to revise existing fees.

Legal advisors should be able to assist members to overcome these obstacles with appropriate drafting in the Sale and Purchase Agreement and by employing a range of pragmatic measures, but as contracts tend to form one of a provider's most valuable assets, organisations will needs to have a strategy around how risks can be mitigated and ultimately allocated.

### 3.4 Stakeholders

The nature of the services provided by members are often extremely personal in nature and can be subject to intense scrutiny from relatives as much as from the regulator. The sale of such services can be contentious; where the client or their families are concerned standards will fall, there will be a change in staff with whom the service recipient has established close ties or simply a sense that the parties have not been involved in the process.

Where individuals receive care and support through a direct payment, a disposal may even result in the loss of customers as those clients "*vote with their feet*" and move to another provider.

Where a patient or service user is wholly or partially funded by a public body, they may even attempt to disrupt a transaction by claiming a breach of the Human Rights Act (Article 8 (Right to Respect for one's Private and Family Life, Home and Correspondence)) or a failure to meet the implied public law right to consultation. In reality it is unlikely that any such claim would be successful, but the adverse publicity and simply the manpower in defending such a claim at a time when resources are already stretched as a result of the transaction, is a less then welcome distraction.

Managing communication to service users, families and staff when a disposal may be under wraps is obviously a difficult process to manage but engendering a sense of inclusion amongst stakeholders can pre-empt the above adverse consequences. As above, where charities are involved the reaction of donors or other benefactors will need to be considered.

### 3.5 Branding and reputational factors

There are a number of issues in this area which will apply to any disposal; for example on an asset sale who continues to have the right to use the name; on a share sale whether the brand should be transferred out of the target before the sale and then licensed back where the Seller wishes to continue to use the name in the remaining parts of its business; whether in the latter case there needs to be a suitable co-existence agreement; in a *true* merger the name of which organisation will take precedence etc.

In the HSC sector there are a few additional factors which can have substantive practical implications. One issue is the reputation of the target in the sector. Sometimes a sale is actually triggered by repeated, poor regulatory ratings and a loss of confidence in the target from commissioners and service users/patients alike. The impact of this cannot be underestimated. One (somewhat cosmetic) means of overcoming this would be a rebrand once the target business has transferred, but inevitably if there are long standing and/or entrenched problems with the service (s), the Buyer should be prepared to invest significant money, time and other resources in remodelling/improving governance and management structures.

Another area which can be especially important in the sector is where there is a divergence between the perception of the existing and target businesses. One example would be the acquisition of an organisation providing forensic services; this may not be seen as a good fit from a marketing point of view where the core activities involve support for children/young adults with learning disabilities and so measures would be needed to ensure the entities operate under completely different brands.

## 4. Preliminary practical steps and agreements

Every transaction will be different and it would be unrealistic to set a prescriptive timetable, but generally, at a minimum, the following steps will be involved:

- Identification of Target
- Feasibility study; cost/benefit analysis
- Exploring financing options
- Preliminary discussions
- Heads of Terms/Letter of Intent
- Due diligence
- Negotiations
- Completion
- Post completion implementation

In order to assist members in the initial stages, we have prepared two preliminary documents. The first is an NDA and Exclusivity Agreement and is designed to allow the parties to have frank discussions at an

early stage without being concerned over the confidentiality of the information being disclosed or having to compete with third parties before it is even clear whether the deal is viable.

The second document is a template Heads of Terms. This is designed for a share sale and headlines the sort of points the parties should be addressing before moving onto detailed due diligence and wholehearted negotiations. We have also included the front end of such a letter for an asset sale, as much of the other conditions will be similar in both types of transaction.

These agreements and this article are not a substitute for obtaining appropriate legal advice and other appropriate advice and we would of course always urge members to involve legal, tax and accountancy advisors as early as possible in the process.

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If you wish to discuss any of the above please contact either **Emma Young** or the head of her team, **David Browne** at davidbrowne@hewitsons.com.

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