Stock vs. Asset Purchase: Pros and Cons

By: Jeffrey S. Baird, Esq.

Assume that (i) John Smith owns ABC Pharmacy, Inc., which is located on Main Street, (ii) Jim Johnson owns XYZ Pharmacy, Inc., which is located on Elm Street, and (iii) Smith wants to purchase XYZ. Smith has two options: asset purchase or stock purchase.

Asset Purchase

The purchaser of XYZ's assets will be either ABC or a new legal entity owned by Smith (DEF Pharmacy, Inc.). For the purpose of this article, assume that the purchaser will be ABC.

The assets to be purchased by ABC will be XYZ's inventory, non-inventory property (computers, delivery vehicles, etc.) and patient files. Normally, ABC will not purchase XYZ's cash in the bank; it will remain with XYZ after closing. Normally, ABC will not purchase XYZ's accounts receivable; they will remain with XYZ after closing. Having said this, there are instances when ABC will purchase XYZ's receivables at a discount. And there are instances when although the receivables will remain with XYZ, ABC will agree to collect the receivables for XYZ; XYZ will pay ABC for these collection efforts.

As a general rule, ABC will not assume any liabilities of XYZ. An exception might be if ABC agrees to assume XYZ's obligations under a lease or some other type of contract.

After closing (i.e., consummation of the purchase), Johnson will continue to own XYZ. XYZ will have no assets other than (i) the purchase price paid by ABC and (ii) receivables (if XYZ retains the receivables). Out of the purchase price and receivable, XYZ will need to pay its debts.

If ABC absorbs XYZ's assets into ABC's Main Street location, resulting in XYZ's Elm Street location being shut down, then ABC will not be required to obtain a new pharmacy license and DME permit. On the other hand, if XYZ's assets remain at the Elm Street location, and if ABC takes over the Elm Street location, then for that location ABC will need to obtain a new pharmacy license and DME permit.

A challenge for Johnson is possible double taxation. If XYZ is a "C" corporation, then the purchase price paid by ABC for XYZ's assets will be taxed to XYZ. And then when Johnson withdraws the purchase price in the form of a dividend distribution, it will be taxed again. This type of double taxation should not exist if XYZ is either a limited liability company ("LLC") or a Subchapter S corporation.

If XYZ has third party payor ("TPP") contracts, then as a general rule XYZ can assign the contracts to ABC only with the prior written consent of the TPPs.

Before closing, ABC will need to conduct due diligence. Essentially, this means that ABC will "kick the tires" of XYZ so that ABC knows what it is that it is purchasing. Due diligence includes: (i) ABC will order a UCC lien report to determine if there are any recorded liens against XYZ's assets; (ii) determination of whether XYZ's corporate charter, pharmacy license, and DEA permit are in good standing; (iii) review of a sample of XYZ's patient files to determine their completeness and accuracy; (iv) review of leases/contracts that ABC intends to assume; and (v) determination by ABC if, for those TPP contracts that ABC cannot assume, the TPPs will agree to enter into new contracts with ABC.

If ABC is satisfied with the results of the due diligence, then closing will occur. At closing, (i) ABC and XYZ will sign an Asset Purchase Agreement; (ii) XYZ will sign a Bill of Sale; (iii) if permitted by the state and if ABC takes over the XYZ location, then the parties will sign a power of attorney that allows ABC to operate under XYZ's pharmacy license and DEA permit until ABC obtains its own license/permit for the Elm Street location; and (iv) related closing documents will be signed. The Asset Purchase Agreement will contain a number of important provisions, including the following:

- **Representations and Warranties -** Commonly known as "Reps and Warranties," these provisions contain certain promises made by XYZ regarding what is being sold to ABC. Even though the parties to the Asset Purchase Agreement are ABC and XYZ, ABC will want Johnson to personally guarantee the Reps and Warranties. XYZ and Johnson will want the Reps and Warranties to contain the caveat: "To the best of the seller's knowledge." On the other hand, ABC will want all or most of the Reps and Warranties to be absolute (i.e., not conditioned on knowledge).

- **Indemnification -** This will be a cross-indemnification provision that states that each party will indemnify the other party for damages arising out of the actions (or failure to act) of the indemnifying party. ABC will want Johnson to personally guarantee this provision.

- **Noncompete -** ABC will want XYZ and Johnson to agree to a reasonable noncompete provision.

There is an old saying: "Possession is 9/10ths of the law." ABC will want to hold back a percentage of the purchase price to be paid sometime after closing. This will allow ABC to offset against the held back funds in the event that XYZ has breached the Reps and Warranties.

<u>Stock Purchase</u>

The seller will be Johnson. He will sell a "piece of paper" (i.e., his stock certificate). The purchaser can be ABC, resulting in XYZ becoming a wholly-owned subsidiary corporation of ABC. This means that Smith will own ABC that will, in turn, own XYZ. Alternatively, the purchaser can be Smith, resulting in Smith owning two corporations; ABC and XYZ. For purposes of this article, assume that the purchaser of XYZ's stock is ABC.

The purchaser (ABC) will inherit XYZ, "warts and all." This means that XYZ's liabilities, known and unknown, will remain with XYZ after closing. Generally speaking, XYZ's pre-closing liabilities will not be imposed on ABC. And so while ABC should not be liable for XYZ's pre-closing liabilities, in order to keep XYZ operating after closing ABC will need to work with its subsidiary to address the liabilities.

XYZ's NPI, pharmacy license, DEA permit and Medicaid provider number will remain intact with XYZ after closing. In other words, if XYZ remains an ongoing entity on Elm Street, then in most states it will not need to obtain a new pharmacy license, DEA permit and Medicaid provider number. However, before and/or after closing, XYZ will need to submit change of ownership ("CHOW") notifications to the appropriate agencies/entities. TPP contracts *should* also remain intact following closing. However, during due diligence, ABC will want to confirm that this is the case. A number of the TPP contracts will require a CHOW notification before or after closing. Some TPP contracts will state that in order for them to remain in force following the CHOW, the TPP must approve the new owner of XYZ.

Recall that with an asset purchase, following closing Johnson will continue to own XYZ which at that time will essentially be a shell. The opposite is true with a stock purchase. After closing, Johnson will own nothing...except for the money paid to him by ABC. Johnson will want to walk away from closing without having any liability for the pre-closing activities of XYZ. From ABC's viewpoint, it will be important that the Stock Purchase Agreement not to allow this to happen. Because Johnson, individually, is the seller, it be important that the Reps and Warranties section of the Stock Purchase Agreement impose clear obligations on Johnson in the event that after closing, ABC discovers that certain Reps and Warranties were not accurate. As discussed above, Johnson will want as many of the Reps and Warranties as possible to be contingent on Johnson's "knowledge." Conversely, ABC will want as many of the Reps and Warranties as possible to be absolute. In a stock purchase, it is particularly important that a portion of the purchase price be held back until after closing. This will give a pool of money for ABC to offset against in the event that Johnson breached his reps and warranties. As with an asset purchase, the Stock Purchase Agreement will need to include an indemnification section and a noncompete.

Because the liabilities (known and unknown) will remain with XYZ after closing, it will be particularly important that the due diligence be thorough. ABC will accept a few "skeletons in the closet"...so long as ABC knows what those skeletons are. For example:

- ABC will need to determine how XYZ secures its patients. Who refers to XYZ? Is XYZ's relationships with physicians, hospital and other referral sources legally compliant...or do the relationships potentially violate federal and state anti-fraud laws such as the federal anti-kickback statute and the federal Stark physician self-referral statute?

- ABC will need to look at XYZ's marketing programs. Are they proper or do they, for example, violate the federal beneficiary inducement statute?

- Does XYZ have a proper compliance program? Equally as important, does XYZ have a proper HIPAA compliance program?

- ABC will need to review past, current and ongoing audits, investigations and litigation. Adverse results from past audits and investigations will likely indicate that XYZ has systemic compliance problems.

Assuming that ABC is satisfied with the results of the due diligence, then closing will occur. At closing, (i) the parties will sign a Stock Purchase Agreement, (ii) Johnson will sign a Stock Transfer, and (iii) related closing documents will be signed.

***Jeffrey S. Baird, JD, is Chairman of the Health Care Group at Brown & Fortunato, PC, a law firm with a national health care practice based in Texas. He represents pharmacies, infusion companies, HME companies, manufacturers and other health care providers throughout the United States. Mr. Baird is Board Certified in Health Law by the Texas Board of Legal Specialization, and can be reached at (806) 345-6320 or** jbaird@bf-law.com.*

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