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How Bankruptcy Can Maximize Health Care Businesses' Value

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Health care businesses, particularly health care facilities and physician practice groups, currently face significant challenges as the industry continues its transition from traditional fee-for-service models that compensate providers for procedures performed toward so-called "value-based" models that compensate based on the results of services. In addition, these businesses must comply with laws such as the Patient Protection and Affordable Care Act, which requires additional reporting and costly business improvements while simultaneously reducing government reimbursement for certain programs. This confluence of new regulations and lower reimbursement rates is causing distress for many providers who often do not have sufficient capital to comply. Exacerbating this stress is uncertainty over whether the existing regulations will remain in effect or be replaced. Thus, many of these providers are either partnering or merging with other providers to achieve economies of scale, resulting in an unprecedented level of consolidation within the industry.

In 2016, merger and acquisition transactions in the health care industry slowed from their record pace in 2015, but still approached $71.7 billion in the United States.[1] Deal volume was down 15 percent; however, the disclosed value of those deals was up over 200 percent in the second quarter of 2017, compared to the second quarter of 2016,[2] which reflects an unusually high number of megadeals.

The consolidation of financially troubled companies can be effectively achieved through the bankruptcy sale process. For health care businesses in particular, bankruptcy sales can maximize the value of these businesses by providing buyers with flexibility in deciding which assets they will buy and offering myriad protections that are typically unavailable in the traditional M&A process. Purchasers thus may be willing to pay more for these assets because the potential risk associated with acquiring them is reduced. Such sales are not a cure-all, however, and parties should be aware of potential pitfalls when considering their consolidation strategy.

This article is intended to summarize bankruptcy sales generally and discuss certain sale considerations that are unique to health care businesses.

Bankruptcy Sales Generally

Asset sales in bankruptcy are attractive for buyers because assets may be acquired "free and clear" of any liens, claims or encumbrances, with such interests attaching to the sale proceeds instead.[3] Although the protections afforded by a bankruptcy sale order are not absolute, a buyer typically has the

ability to “cherry-pick” favorable contracts, and anti-assignment clauses in those contracts generally are unenforceable.[4] Thus, bankruptcy sales afford buyers the opportunity to get the benefit of favorable contracts while at the same time limiting significantly, the liabilities the buyer will assume in the acquisition.

Yet, there are some disadvantages to a bankruptcy sale. For example, unlike sales outside of bankruptcy that can be negotiated in private between a seller and buyer, bankruptcy sales are subject to the scrutiny of multiple parties that may include the bankruptcy judge, a creditors committee of unsecured creditors, prepetition and/or post-petition lenders, other bidders and the U.S. trustee. On the other hand, buyers may be comforted by the disclosures and scrutiny to which the debtor is subjected during its bankruptcy case.

There are two principal means of selling assets in bankruptcy: (1) pursuant to a motion under Section 363 of the Bankruptcy Code (a “363 sale”); or (2) through a plan of reorganization under Section 1123 of the Bankruptcy Code (a “plan sale”). Both methods have several common factors. Courts typically require that sales be conducted on notice to all interested parties and generally require that an auction be conducted to ensure that the sale price for the assets reflects the “highest and best” price.[5] In either case, the debtor, working with its professionals, will identify potential bidders and typically will try to get a bidder to sign an asset purchase agreement. The debtor will seek bankruptcy court approval to consummate the sale with the initial (or so-called “stalking horse”) bidder, subject to higher and better bids at an auction.[6]

The debtor also will seek approval of so-called “bid procedures” that will govern the auction. During this time, the prospective buyer and other qualified bidders complete their due diligence and address any other issues that will be necessary to consummate the sale, while the debtor continues to market its assets. The debtor then conducts the auction and then seeks court approval of the transaction evidenced by the highest or otherwise best bid received.

Benefits of 363 sales include that they typically are faster and less expensive than plan sales. Typically, 363 sales may close within 50 to 75 days after the debtor files for bankruptcy,[7] whereas plan sales may close within 90 to 110 days after the petition date, although they can often take far longer. Plan sales, on the other hand, may have tax advantages because sellers and buyers may be able to avoid paying transfer taxes, and a buyer can purchase the assets with equity, whereas 363 sales typically are cash-only transactions.

Bankruptcy Sale Considerations For Health Care Businesses

There are several factors that sellers and buyers of health care assets should consider when structuring an asset sale. We note at the outset that this list is intended to be illustrative and not exhaustive.

Sale of Provider Agreements

Many buyers will want to purchase the seller’s provider agreements under the Medicaid and Medicare programs. Under the Bankruptcy Code, provider agreements typically are considered “executory contracts” that may be assigned to a buyer.[8] To assign a provider agreement, however, a debtor must first cure any pre-bankruptcy defaults related to the agreement. If the buyer takes an assignment of the existing provider agreements, then it will receive an uninterrupted stream of payments. It also, however, assumes liability for overpayments made to the debtor prior to the assignment of the provider agreement and any civil liability asserted by the government against the previous owner.[9] Thus, sellers

and buyers often seek the consent of (and/or settlement with) the Department of Health and Human Services (HHS) before assigning a Medicare provider agreement and with local state authorities before assigning a Medicaid provider agreement.

While the buyer may elect not to purchase the provider agreements if there is significant liability associated with that agreement (or even if the liability is uncertain), not doing so will require the buyer to undergo a lengthy re-enrollment process to obtain its own provider number. The delay in obtaining a new provider number may make a proposed acquisition less attractive because the buyer will not have the benefit of a stream of payments while waiting to obtain its new provider number. Medicare payments typically represent a substantial portion of receivables that a buyer will acquire, and thus, a buyer could lose significant revenue from the period between closing on the asset purchase and obtaining its own provider number. There are some workarounds to this problem. For example, the buyer and seller may enter into a management agreement whereby the buyer may operate the facility using the seller's provider number until its own provider number is issued. Alternatively, the parties may agree to delay the closing until the new provider number is issued, to a reduced purchase price to account for the potential payment gap, or arrange for an escrow of a portion of the sale proceeds for some period to indemnify the buyer for any liability.

Note also that federal and state governments may cancel a provider's Medicare and Medicaid provider agreements. Recently, a Florida nursing home attempted to use the Bankruptcy Code's automatic stay to stop HHS and the Florida Agency for Health Care Administration from terminating its provider agreements while it attempted to correct violations the agencies had asserted against the bankrupt provider.[10] On appeal, the Eleventh Circuit held that the broad jurisdiction bankruptcy courts have in managing a debtor's estate does not prime HHS' authority to manage compliance with Medicare regulations, and that the debtor was required to exhaust administrative remedies before seeking a stay. Given that bankruptcy courts may not have jurisdiction to stop governments from terminating provider agreements, it's critical that purchasers discuss any outstanding federal or state violations with buyers early in the diligence process.

Successor Liability

HHS has shown a willingness to assert successor liability against asset buyers for all liabilities imposed on the seller; however, as discussed above, bankruptcy sales typically permit a buyer to acquire assets free and clear of such liabilities. Nevertheless, it is incumbent on the buyer when negotiating an asset purchase agreement and sale order to specify what liabilities it will assume. Any voluntary assumption on the part of a buyer may itself create successor liability even in circumstances where the bankruptcy court otherwise is willing to limit the buyer's liability. Failing to include language in a sale order specifically releasing the buyer from certain claims can result in unexpected liabilities.

Highest Bid May Not Win Auction

In most bankruptcy cases, the highest bidder wins the auction. However, in health care provider bankruptcy cases, courts also consider the preservation of the provider's services in the community. The tension between highest offer and community interest played out in In re United Healthcare System Inc.[11] In this case, United Healthcare System, a not-for-profit, operated a children's hospital and an acute care facility in Newark, New Jersey. In dire straits, United solicited bids for its assets, and four bidders responded. The commissioner of health and senior services of New Jersey, citing the urgent need to continue health care services to the community, required that the sale be completed in one month. United's board of trustees, working with the commissioner, selected a bidder, "St. Barnabas,"

that had a significant presence in New Jersey. To facilitate the sale, the commissioner provided a certificate of need authorizing the closing of the debtor's hospital and granted St. Barnabas a license to operate the children's hospital. St. Barnabas, however, wanted to avoid assuming many of United's liabilities, and thus, the purchase agreement required that United file for bankruptcy so that the assets could be sold in a 363 sale.

United filed for bankruptcy and immediately sought bankruptcy court approval of its proposed private sale to St. Barnabas. One of the four pre-bankruptcy bidders whose bid was not selected, however, objected to the sale and submitted an unsolicited bid that it asserted was higher and better than the one proposed by United and St. Barnabas. After a four-day hearing, the bankruptcy court concluded that the new bid was higher.[12] Thus, the bankruptcy court held that the St. Barnabas sale could not be approved because, among other things, the board's decision to award the sale to St. Barnabas "was not a sound business judgment" and "defeated the ability of [the Bankruptcy] Court to carry out its function to obtain a fair price for the debtor's assets for the benefit of the creditors of this estate."[13] As a result, the bankruptcy court voided the St. Barnabas sale and requested that the commissioner reinstate the debtor's certificate of need for a 10-day period to allow the bankruptcy court to conduct an auction.

On appeal, the district court reversed the bankruptcy court's decision to void the sale. The district court held that the bankruptcy court had substituted its judgment for that of the board and did not consider the totality of the circumstances. The district court highlighted the need in cases such as this to consider the public health and pointed out that the accelerated timetable was mandated by the commissioner and the result of urgent need within the community. Thus, the district court concluded that it could not "mechanically apply bankruptcy principles of 'highest and best' offer."[14]

Hill-Burton Obligations

The Hill-Burton program is a federal loan and grant program that provides for the construction and modernization of not-for-profit and public health care facilities. Recipients of Hill-Burton funds obligate themselves to: (1) provide uncompensated care for either 20 years or perpetually; (2) provide community service, including participation in Medicare and Medicaid; and (3) complete certain compliance reporting. The government may recover grant funds used for the construction or modernization of a facility if, within 20 years after completion of the construction or modernization, the facility is: (1) sold or transferred to an entity that is not qualified for a grant or not approved as a transferee by the state agency; or (2) ceases to be a public or other not-for-profit hospital, outpatient facility, facility for long-term care, or rehabilitation facility. A "transfer" occurs when the facility is conveyed to another entity through lease, merger, bankruptcy, foreclosure or other arrangement.

The government is entitled to recover a portion of the original grant funds based generally on the percentage of federal funds used in construction or modernization of the facility. Under certain circumstances, the government may waive its recovery rights. Regardless of the government's failure to participate in a bankruptcy case, the government may recover grant funds from a transferee and any subsequent transferee.

Sale Closing Delays

Regulatory approval of a sale often will occur after the approval by the bankruptcy court. This means that the time between the bankruptcy court's approval of a sale and when the sale can close may take several months, or longer. In some cases, a sale may not close until more than one year after the bankruptcy court authorizes the sale.

Conclusion

Bankruptcy can be a valuable tool for troubled health care businesses during the current cycle of consolidation. Bankruptcy sales often are an effective means for buyers to purchase assets; however, particularly in the health care arena, it is critical that sellers and buyers consult counsel early in the process to identify and avoid potential hazards.

Further, it is important for sellers and buyers to pick the right partner. Successful mergers in the health care industry should result in increased services at reduced costs while catering to particular patient populations. A strategic misstep can result in a future bankruptcy for the acquirer. In fact, a 2015 study stated that one of the top causes of distress in the health care industry was poorly integrated mergers that burden the acquirer.[15]

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[1] U.S. Health Services Deals Insights Year-end 2016, PricewaterhouseCoopers Deals Practice (September 2017), available at https://www.pwc.com/us/en/healthcare/publications/assets/pwc-health-services-deals-insights-q4-2016.pdf.

[2] Q2 2017 U.S. Health Services Deals Insights, PricewaterhouseCoopers Deals Practice (September 2017), available at https://www.pwc.com/us/en/health-industries/publications/assets/pwc-health-services-deals-insights-q2-2017.pdf.

[3] Bankruptcy Code Section 363(f) provides:

> (f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if —
>
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
> (2) such entity consents;
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
> (4) such interest is in bona fide dispute; or
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Although Section 363(f) only speaks in terms of a sale free and clear of “interests,” courts generally interpret that term broadly to include not only liens and secured claims, but also other kinds of claims, such as general unsecured claims with a connection to the acquired property.

[4] A debtor's right to assume and assign contracts is not absolute. For example, a debtor may not assign certain intellectual property contracts.

[5] The Bankruptcy Code also permits private sales; however, they generally are disfavored.

[6] In some instances, the debtor may seek to sign up the stalking horse prior to commencing the bankruptcy case in order to expedite the sale process.

[7] 363 sales can occur much faster than 50 to 75 days if there are exigent circumstances justifying a faster sale process.

[8] While not defined in the Bankruptcy Code, executory contracts generally are considered to be "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. R. 439, 460 (1973); In re Murexco Petroleum Inc., 15 F.3d 60 (5th Cir. 1994); In re Texscan Corp., 976 F.2d 1269 (9th Cir. 1992); United States v. Floyd, 882 F.2d 235 (7th Cir. 1989); Sharon Steel Corp. v. National Fuel Gas Distrib. Corp., 872 F.2d 36, 39 (3d Cir. 1989); In re Speck, 798 F.2d 279, 279-80 (8th Cir. 1986); Gloria Mfg. Corp. v. International Ladies Garment Workers' Union, 734 F.2d 1020, 1021 (4th Cir. 1984); In re Chateaugay Corp., 130 B.R. 162, 164 (S.D.N.Y 1991).

[9] Deerbrook Pavilion LLC v. Shalala, 235 F.3d 1100, 1103-05 (8th Cir. 2000); United States v. Vernon Home Health Inc., 21 F.3d 693, 696 (5th Cir. 1994).

[10] See Fla. Agency for Health Care Admin. v. Bayou Shores SNF LLC (In re Bayou Shores SNF LLC), 828 F.3d 1297 (11th Cir. 2016).

[11] In re United Healthcare Sys., 1997 U.S. Dist. LEXIS 5090 (D.N.J. Mar. 26, 1997).

[12] Id. at *18.

[13] Id. at *9.

[14] Id. at *21 ("Courts are not experts in public health and safety issues and this Court bows to the knowledge of the Commissioner in those areas. If the Commission felt that there was a public need for the Children's Hospital to be operated as a unit in northern New Jersey, federal courts should accept it as such.").

[15] Polsinelli/TrBK Distress Indices Special Report: Causes of Healthcare Distress in 2014 (August 2015), available at https://www.distressindex.com/special/causes-healthcare-distress-2014.