The Latest in Financial Stabilization and Recovery Options for Hospitals and Health Care Businesses Post-COVID

January 26, 2021
2:00 – 3:30 PM EST

AMERICAN HEALTH LAW ASSOCIATION

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BACKGROUND AND CONTEXT

- Rising Hospital Bankruptcies and Closures, Particularly Among Rural and Safety Net Hospitals:
  - At least 20 hospitals entered bankruptcy between 2016 and 2018 (Fierce Healthcare, November 1, 2018)
  - At least 30 hospitals entered bankruptcy in 2019 alone (Bloomberg, January 9, 2020)
  - 6 hospitals closed their doors in the less than 60-day period between December 1, 2019 and January 27, 2020 (Becker's Hospital Review, January 27, 2020)
  - 897 hospitals at risk of closing (Becker's Hospital Review, January 24, 2021)

- Distressed hospitals in headlines daily beginning March 2020 - Examples
  - *Coronavirus Threatens Rural Hospitals Already at the Financial Brink* (NPR, March 21, 2020)
  - *Healthcare's Looming Financial Implosion* (Modern Healthcare, March 20, 2020)
  - *COVID-19 Poses Long Term Impact for Not-for-Profit Hospitals* (Modern Healthcare, March 19, 2020)

Presenters

The Latest in Financial Stabilization and Recovery Options for Hospitals and Health Care Businesses Post-COVID

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FEDERAL AND STATE CORONAVIRUS RELIEF ACTIONS

Todd Baumgartner
Gary F. Torrell

Reimbursement Changes

- New Rural Emergency Hospital Medicare designation.
- Eliminates the 2% Medicare sequester cuts through March of 2021
- $3 billion in increased payments for physician services under the Medicare Physician Fee Schedule for 2021
- Eliminates $4 billion in Medicaid DSH cuts

Tax Benefits

Significant benefits:

- PPP expenses are now deductible
- Employee retention credit

Employee Retention Credit Eligibility

- Full or partial suspension of operations due to restrictions
- Significant decline in revenue of 50% or more compared in a quarter from 2020 to 2019
- Can now claim tax credit on any wages not used to support PPP forgiveness.

Value of Credit

- Retroactively effective to 2020.
- 50% of “qualified wages” up to $10,000 per employee.
- Employer’s portion of 6.2% FICA tax
- Refundable amounts offset other employment tax obligations.

Qualified Wages – Small Employers

- All employee wages during an impacted quarter
- Employer health plan expenses

Qualified Wages – Large Employers

- Wages paid by employers to employees who are not performing services.
- Employer share of employer healthcare plan expenses

2021 Extension Until June 30th

- Eligibility – Shut down or suffered a decline of 20% or more in gross receipts when comparing the 2021 quarter to 2019

PPP Loans – Take 2

Available to previous PPP Borrowers Up to $2 million, if Borrower:

a. has 300 or fewer employees;
b. used or will use all proceeds from first PPP loan; and
c. had 25% or greater drop of gross receipts for any quarter in 2020 compared to same quarter in 2019.

Conditions for Every PPP-2 Loan

a. Cannot exceed $2 million.

b. Maximum loan amount based on 2.5x average monthly payroll costs in one year time period before the loan or in calendar year 2019.

c. Must use at least 60% of loan proceeds for payroll. Can use the rest for payroll, health insurance premiums, retirement costs, mortgage interest, rent, utilities, operating and capital expenses to comply with COVID-related governmental health safety guidelines, essential operational costs paid to a supplier, business software and cloud computer services, to repair property damage, vandalism or looting during 2020 if not covered by insurance or other compensation, and premiums for group life insurance and disability insurance.

BANKRUPTCY – AN OPTION FOR RESTRUCTURING AND RECOVERY

Gary Torrell

1. When Bankruptcy Should Be Considered.

a. COVID-19 / Declining Patients: Fewer patients seeking medical care due to fears of contracting COVID-19.

b. Reimbursement Challenges: Reductions in Medicare and Medicaid payments.

c. Exit Strategy: Ideal vehicle to restructure debt, sell assets.

d. Mismanagement or Fraud: Opportunity to replace management and instill trust in reorganization or sales process.

e. Competition with other local hospitals or specialty practices.

2. Benefits of Bankruptcy.

a. The Automatic Stay.
   (1) Stops, with certain exceptions, all pending lawsuits and proceedings.
   (2) Prevents creditors holding pre-petition claims from attempting on to collect outside of bankruptcy.
   (3) NOTE: With limited exceptions, the automatic stay does not stay litigation against non-debtor parties.

b. Debtor-in-Possession (DIP).
   (1) Chapter 11 DIP generally remains in possession and control of the assets and business operations.
   (2) Officers and Directors continue to make decisions (some require court approval), unless a Trustee is appointed for cause.
   (3) DIP is treated as a new entity as of the petition date, and owes fiduciary duties to all creditors.
   (4) DIP may engage in ordinary course of business transactions without court approval.
   (5) DIP may file lawsuits to recover money paid or property transferred to creditors and other parties pre-petition, because the transfers were preferential or fraudulent.

3. Potential Downsides of Bankruptcy.

a. Appointment of Chapter 11 Trustee or Examiner.
b. Case may be converted to Chapter 7 if debtor is administratively insolvent or unable to confirm a plan.

(1) Chapter 7 Trustee is appointed to take control and possession of the estate's assets. The Chapter 7 Trustee may seek authority to operate the debtor's business, but this is done rarely.
(2) Trustee can pursue claims against insiders as well as other creditors.

c. Case may be dismissed for "cause" including bad faith.
d. Chapter 11 is expensive.

4. Bankruptcy Options.

a. Chapter 7 (liquidation)

b. Chapter 11 (reorganization)

c. Subchapter V of Chapter 11 (small business reorganization)

- Debtor may have up to $7.5M of liquidated debt for cases filed by 3/27/2021
- Only debtor may file a plan
- Owner may retain stake in debtor
- Typically no creditors' committee or disclosure statement
- Standing trustee appointed with limited duties

5. Key Events During Bankruptcy Case.

a. Financing a Chapter 11-Section 363.

(1) Use of Cash Collateral.

A. Consensual.

B. Contested.

(2) DIP Financing.

A. Consensual.

B. Contested.

C. Priming Liens and Roll-ups.

5. Key Events During Bankruptcy Case. (cont'd.)

b. Sale of Assets Outside Chapter 11 Plan-Section 363.

(1) Sales can be piecemeal or include substantially all assets.

A. Court-Approved Auction Process: Bidding procedures and bid protections in advance of the auction. Bid protections often include:

(i) [illegible] for the stalking horse bidder;

(2) Role of State Attorney General.

(3) Role of federal agencies and licensing authorities – Medicare/Medicaid.

(4) Role of state agencies and licensing authorities.

5. Key Events During Bankruptcy Case. (cont'd.)

c. Executory Contracts and Leases-Section 365.

(1) DIP may assume, assume and assign, or reject most executory contracts and unexpired leases.
(2) Contracts are executory where material obligations remain unperformed by each party.
(3) DIP must "cure" all monetary defaults as a condition to assumption.
(4) Counterparty to executory contract and unexpired leases may demand adequate assurance of future performance by buyer.
(5) Rejection option enables DIP to drop undesirable contracts and leases.
(6) Exceptions to Assignability

A. Personal service contracts.
B. Intellectual property licenses.
C. Some government contracts.

5. Key Events During Bankruptcy Case. (cont'd.)

d. Medicare and Medicaid Provider Agreements.

(1) Medicare is governed by 42 C.F.R. § 489.18(c), which provides that when "there is a change of ownership ... the existing provider agreement will automatically be assigned to the new owner."

A. New owner assumes obligation to repay the Department of Health & Human Services for any of the (debtor) assignor's accrued Medicare or Medicaid overpayments at the time the overpayments were made or discovered.

B. Bankruptcy limitations.

(i) If a Medicare and Medicaid provider agreement is ruled to be an executory contract under section 365, DIP may assume or reject the agreement, but DIP may not assume the agreement unless all defaults are cured or DIP provides adequate assurance of prompt cure.

(ii) If the Medicare or Medicaid provider agreement is ruled to not be an executory contract, the buyer may acquire the assets free and clear of such obligations under section 363.

5. Key Events During Bankruptcy Case. (cont'd.)

(2) Split Authority:

A. [illegible]
B. [illegible]
C. [illegible]
D. [illegible]

5. Key Events During Bankruptcy Case. (cont'd.)

(3) Rights of Recoupment and Setoff.

A. Ability of Medicare to recoup pre-petition overpayments from post-petition obligations, essentially cutting off a DIP's lifeline of Medicare reimbursement.

B. Split of Authority.

(i) No recoupment permitted.

(a) [illegible]

(ii) Recoupment permitted.

(a) [illegible]

6. Special Bankruptcy Code Provisions Governing Healthcare Businesses

a. What is a "Healthcare Business?"

(1) Defined in 11 U.S.C. § 101(27A):

A. Public or private entity (whether "for profit" or "non-profit") that is primarily engaged in offering to the general public facilities and services for—

(i) the diagnosis or treatment of injury, deformity, or disease; and
(ii) surgical, drug treatment, psychiatric, or obstetric care.

B. Includes-- any—

(i) general or specialized hospital;
(ii) ancillary ambulatory, emergency, or surgical treatment facility;
(iii) hospice;
(iv) home health agency;
(v) other health care institution that is similar to any of the foregoing entities; and
(vi) any long-term care facility, including any—

(a) skilled nursing facility;
(b) intermediate care facility;
(c) assisted living facility;
(d) home for the aged;
(e) domiciliary care facility; and
(f) health care institution that is related to a facility referred to above, if that institution is primarily engaged in offering room, board, laundry, or personal assistance with activities of daily living and incidentals to activities of daily living.

6. Special Bankruptcy Code Provisions Governing Healthcare Businesses (cont'd.)

b. Patient Care Ombudsman-Section 333.

(1) Requires appointment of a patient care ombudsman in every Chapter 7 or 11 case filed by a health care business within 30 days after start of the case, unless the court finds ombudsman is not necessary for the protection of patients.

(2) Ombudsman monitors quality of patient care and represents the interests of patients. The ombudsman must file a report with the bankruptcy court every 60 days regarding the quality of patient care. If any serious matters arise and quality of patient care declines significantly or is materially compromised, the ombudsman may notify the Court.

(3) Ombudsman must be disinterested and is paid by the bankruptcy estate.

(4) Ombudsman may facilitate a sale or reorganization by helping to maintain patients at the facilities and give patients and their family comfort knowing that the quality of care will continue.

c. Consumer Privacy Ombudsman-Section 332.

(1) If DIP has a privacy notice that prohibits transfers of personally identifiable information, the Bankruptcy Court must order the United States Trustee to appoint a Consumer Privacy Ombudsman prior to a sale involving such personally identifiable information.

(2) Consumer Privacy Ombudsman may appear and be heard at the sale hearing.

TRANSACTIONAL OPTIONS FOR RESTRUCTURING AND RECOVERY

Steve Clapp
Todd Baumgartner
Gary F. Torrell

Questions for Board, Executives Prior To Evaluation of Restructuring Options

- What is the board's/management's primary goal/mission?
- What is my fiduciary responsibility as a board member, executive?
- What is the company's viability post-restructuring?
- What impact will re-structuring (or re-emerging from bankruptcy) have on our company's capabilities (financing, community reputation, medical staff recruitment, employee recruitment, etc.) post-restructuring?
- Can I be personally liable:
  - in a non-profit hospital/health system?
  - If the non-profit has D&O insurance coverage?
  - if there was no "gross negligence"?

Re-structuring Considerations

- Ensure a detailed understanding of company's cash position
  - Create a 13- or 17- week cash flow forecast of receipts and disbursements
- Know your financing documents, covenants
  - Know your loan/debt documents and financial covenants
  - Know your lenders
  - Secure DIP lender
- Communications plan for all constituents (physicians, employees, community, lenders, vendors, etc.)
  - Ensure all of your constituents are included in the plan with messages tailored to their specific needs
- Seek experienced advisors
  - Select experienced distressed advisors – counsel, financial advisor, etc.

Transactional Options

- Determine if remaining independent is a viable option or do you need to affiliate.
- How to choose which organization to affiliate?
- What deal points should you be prepared to negotiate to protect the hospital, the employees and the community?

Do you need to affiliate?

- Is the hospital financially viable?
- Will the hospital benefit from a reduction in operating expenses?
- Acquired hospitals in the study were actually able to cut annual operating expenses by 2.5 percent – or $5.8 million.
- Mergers typically expanded the scope of services available to patients by providing more comprehensive and efficient care.

How do you affiliate?

- Retain an experienced transactional advisory firm
- Conduct a SWOT analysis
- Compile a list of strategic goals for an outcome of the merger.
- Solicit RFPs from potential partners to determine which partner will accommodate your hospital's goals

Strategic Goals

- Nonprofit or For Profit?
- Financially Healthy Partner?
- How much control can you have post-affiliation?
- Employees hired at new facility at existing compensation levels.

Key Deal Points

- Ensure the continued existence of a hospital system in for the benefit of its residents.
- Include requirement that the acquiring health system invest a minimum amount of capital in the your system.
- Ensure foundation is used for the benefit of residents of your region.
- Purchase Tail Insurance
- Who enforces these provisions?

CASE STUDY #1

Gary F. Torrell

Two-Step Hospital Sale-Silverlake Medical Center

- Promise Healthcare solicits bids for facility; client's bid selected for private sale
- Eight month negotiation over sale contract; existing lender takes action when sale is about to close
- Promise files Chapter 11 and uses section 363 to sell several facilities piecemeal, including Silverlake Medical Center
- Client becomes stalking horse bidder; auction/sale process takes six months
- Creditors' committee, landlord and governmental objections to sale
- Alternate bidder disrupts sale process but decides to bid instead for a hospital in Verity Healthcare Chapter 11 case

CASE STUDY #2

Todd Baumgartner

Strategic Transaction

- 70 bed, nonprofit rural hospital
- $2.5 million foundation
- Persistent cash flow and census issues

Affiliation Search

- Board determined remaining independent was not in best interest of the health system
- Retain consultant and performed a search
- Identified 3 potential partners
- Conducted due diligence on all 3 potential partners

Finalize Transaction

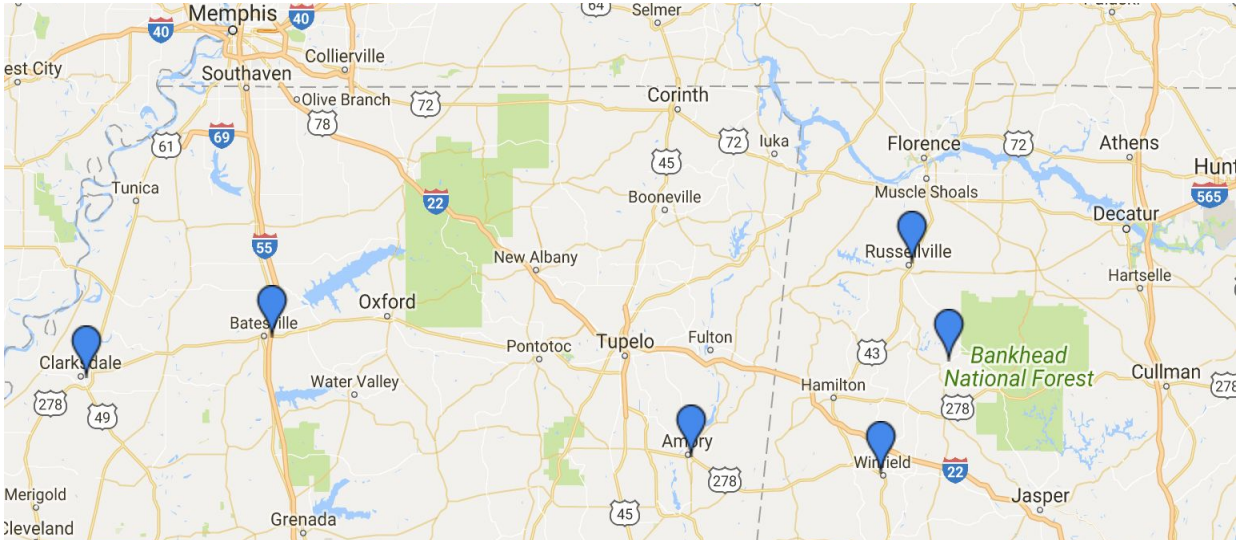
- Chose 300 bed health system as its partner
- 18 months to close transaction after retaining affiliation adviser
- Structured as a member substitution
- $20,000,000 capital improvement commitment
- Foundation was restructured to be independent of new facility
- Obtained Board Seats in new health system
- Retained local Board
- Commitment to keep acute care hospital open for 5 years
- Employee compensation commitment for 1 year

CASE STUDY #3

CURAE HEALTH: RESTRUCTURE OR EXIT?

Steve Clapp, FACHE
President
Strategic Healthcare Advisers

Curae Health



Statistic	Curae – AL	Curae – MS	Total
# of Hospitals	3	3	6
Licensed beds	230	402	632
FTEs	493	935	1,374
Net Revenue	$62.9	$144.2	$207.1M
Total Assets	$39.4	$111.6M	$151.0M

Concept:

- Operates as not-for-profit
- Utilize experience in managing small community hospitals to achieve efficiency and sustainability
- Provide turnaround expertise and management skills not generally available to small rural facilities
- Create new services and new jobs that have left the area
- Understand and interact with rural communities
- Engage hospital medical staff to help improve clinical quality, hospital service, financial performance, etc.
- Willingness to affiliate/partner with regional tertiary partner

Pre-Transaction Diligence

- Hired regionally/nationally known firms to assist with valuation, real estate appraisal, and Quality of Earnings study
- Review of all contracts, cost reports, facilities, etc.
- 15+ site visits to each hospital prior to acquisition
- Conservative pro-forma modeling - Little to no volume growth, no reimbursement improvements, no staffing changes, etc.; only major changes were overhead reduction and conversion to not for profit
- Operations plan to be implemented at or post-closing

Factors Creating Financial Pressures and Obstacles in Rural Markets

- ***Significant decline in revenue post-acquisition – $22 million over 20 months***
- ***Delays in "Extender payments" (several months before reinstated and reimbursement "caught up") – $3.1 million***
- ***Inability to secure term debt post-closing for information system conversion (backup plan was to have lender providing financing)***
- Other Factors Impacting The Broader Rural Market:
  - Erosion of volumes in rural markets due to "Bigger is better" mindset by some patients
  - Declining populations, demographics
  - Inability to recruit physicians who desired "traditional practice"
  - Medicaid expansion in some states

Re-Structuring Activities, Experiences

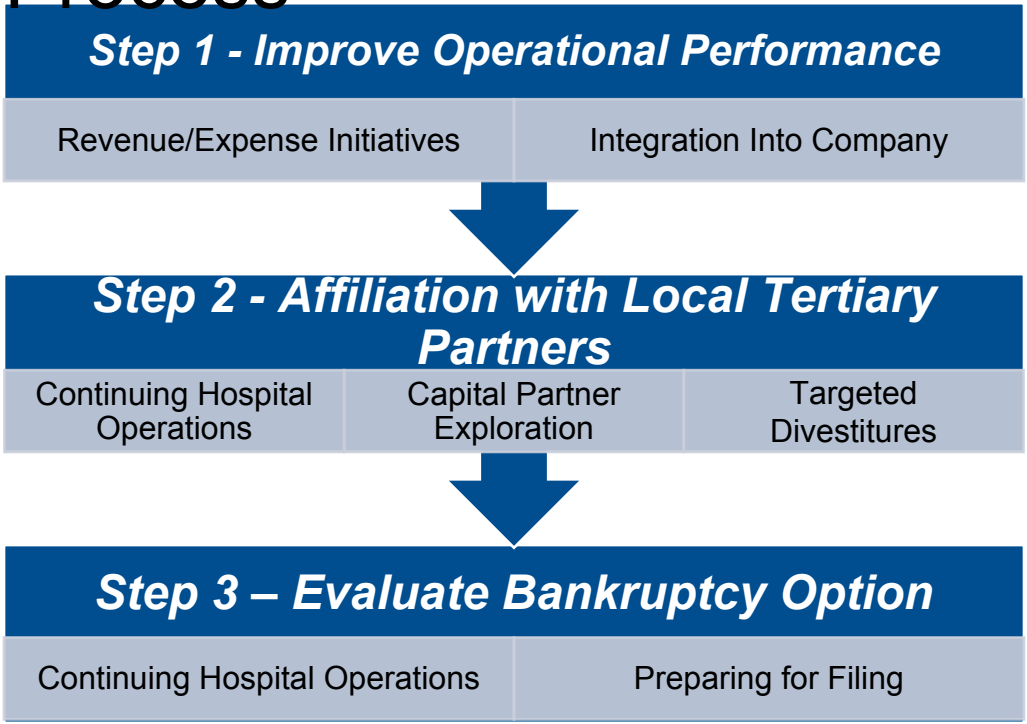
Activities:

- Board/Management assessment of options
- Communication plan (for all constituencies)
- Continuing Operations (Payroll, patient care and quality, supply delivery, ER/Hospitalist/Other Contracted Services continuation, etc.)

Experiences:

- Cash tightens impacting professional service contracts, contract services,
- As supplies tighten employees, medical staff, and community get nervous
- Pressure comes from all sides including politicians

Restructuring Decision Process



Key Considerations: (1) Hospitals remain open long term, (2) Cash availability to weather storm, (3) Impact on hospitals' future success if Curae re-structured and re-emerged

Bankruptcy Process

- Selection of ***experienced*** bankruptcy counsel
  - Preparation of First Day Filings
  - Decision: Reorganize vs. Divestiture (and wind-down of Curae)

- Communication plan for all constituencies – Medical Staff, Employees, Community leaders, Lenders, Vendors, etc.

- Securing Debtor in Possession Financing

- Hiring financial advisor

- Selection of personal counsel

Lessons Learned About Bankruptcy

- Review state laws (regarding not-for-profit boards protection and exposure and update your bylaws (if necessary) - ***NOW***
- Continually Inform/Educate the Board Members & Executive Team
- Stay focused on the desired outcome – keeping hospitals open
- Develop thick skin and resolve as the process will be one of the toughest experiences you will ever go through

Summary of Hospital Startup

- The mission of helping rural hospitals was a good thing to do

- Things to remember:
  - Sufficient cash availability
  - Integration of newly acquired hospitals and management
  - Increased pace of corporate culture and process integration

- All the diligence in the world may not protect you in every situation

Impact of Catastrophic Disruptor on Hospitals

- COVID-19 has been an unplanned, catastrophic event in your hospital
- Hospital staff are trained to prepare and drill on emergency situations (tornados, active shooter, contamination situations, etc); we have discussed situations like this but never seen one like it
- Pressure on hospitals is great
  - Cost to deliver care to COVID-19 patients is higher and more intense than typical flu-like patients
  - Significant pressure on staffing and supplies occurs because of the patient acuity, infectious disease risk, community shut down, etc.
  - Replacement of high revenue generating surgery patients with lower paying medicine patients with longer LOS (lengths of stay)
- Have we “kicked the can” relative to the pre-COVID issue with rural hospitals? Will it re-emerge in 2021 when COVID cases and the governmental assistance have subsided?

QUESTIONS?

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