



BUYING A DISTRESSED HOSPITAL OUT OF BANKRUPTCY

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It is an immutable rule of economics that when business conditions change, someone gets hurt. This is as true in the health care industry as it is anywhere else, and the financial basis for the delivery of health care in the United States is experiencing more attention and regulatory revision than at any time since the introduction of Medicare in 1965. Regardless of whether the Supreme Court upholds the Patient Protection and Affordable Care Act, the ongoing regulatory changes to both public and private payment for patient care, as well as the budget restrictions facing governmental payors, will profoundly affect the financial operations of hospitals. Some hospitals, particularly those that are not well-managed, will inevitably suffer and will have no choice but to file for bankruptcy protection.

The financial woes of a hospital in bankruptcy can create an attractive acquisition opportunity. Due to its distressed financial condition, the hospital will typically sell for far less than a financially healthy hospital. Moreover, the bankruptcy process itself can help reposition the hospital for a brighter future.

Bankruptcy Sales. There are two ways a business can be sold in a bankruptcy case, under a plan of reorganization or as an asset sale under Bankruptcy Code § 363. Section 363 sales have become increasingly common in bankruptcy cases because they can be held at any time during the case. Whereas confirmation of a plan requires preparation, negotiation and approval of a full disclosure statement and plan for distributions to creditors, in accordance with lengthy statutory notice periods, an asset sale under Section 363 can be accomplished without resolution of most creditor claims and in a relatively short period of time pursuant to ordinary motion procedures.

The most significant attribute of a sale of assets in bankruptcy is that the sale is “free and clear” of liens, claims and encumbrances other than those that may be expressly provided for in the sale order. The assets are cleansed of the debts that overwhelmed the old company, and the buyer can rebuild the business starting with a clean slate. Moreover, bankruptcy sales enjoy a degree of finality not possible outside of bankruptcy. Pursuant to Bankruptcy Code § 363(m), a bankruptcy sale to a good faith purchaser cannot be reversed or modified on appeal unless there has been a court ordered stay of the sale pending appeal.

Contracts and Leases. Another important feature of bankruptcy sales is the ability of the buyer to “cherry pick” among the debtor’s contracts and leases and leave unprofitable ones behind. Except for “personal service” contracts, such as medical director agreements, which can only be assigned with the consent of the counterparty to the contract, the buyer effectively has complete discretion as to

which contracts and leases it chooses for assumption and assignment. The only requirements are that the buyer demonstrate “adequate assurance of future performance” under the contract or lease, and any monetary defaults are cured at the time of assignment. Notably, loan agreements are not assumable under bankruptcy law, and the buyer must either obtain new financing or make a deal with the existing lender for assumption of the obligation.

Among the most significant contracts in a hospital bankruptcy are the Medicare and Medicaid provider agreements, and a buyer must decide whether to assume the existing contracts or obtain new provider numbers and agreements. If the buyer decides to assume the existing contracts, it will be responsible for any overpayment claims by the government, whether or not known at the time of assignment. If the buyer does not assume the existing contracts, it must obtain new provider agreements, and until those agreements are in place, the buyer will not be paid for services to Medicare and Medicaid patients.

The Sale Process and Timing Issues. A hospital in bankruptcy that sells its assets will nearly always try to negotiate a sale agreement with a “stalking horse” bidder and then file a motion with the Bankruptcy Court for approval of the sale. The sale will be subject to “higher and better” offers at the time of sale, although the question of whether an offer is both higher and better in the hospital context can be affected by nonmonetary considerations such as the interests of the community or employees of the hospital. The advantages of being the stalking horse bidder are that the stalking horse can structure the terms of sale, will usually have a longer time period for conducting due diligence, and can typically negotiate a “break-up fee” (generally about 5% of the purchase price) payable in the event that another buyer is selected as the winning bid.

The sale of a hospital, even in a bankruptcy sale, requires compliance with applicable licensing and regulatory requirements, including state license transfer, change of ownership (CHOW) procedures for Medicare provider agreements, accreditation by the Joint Commission or other accreditation body, transfer of DEA registration, transfer of pharmacy permits, federal and local environmental compliance, compliance with regulations regarding radioactive materials and radiation machines, and compliance with any certificate of need (CON) laws. The sale of a nonprofit hospital to a for-profit entity also requires compliance with state law procedures regarding transfer of charitable assets, usually approval by the state attorney general.



Although governmental authorities can expedite licensing and regulatory approvals, and may wish to do so in order to save a failing hospital, it can nevertheless be difficult to complete the process prior to the Bankruptcy Court hearing on the sale. One possible solution is for the buyer to enter into a management agreement for the hospital, with Bankruptcy Court approval, pending completion of the licensing and approval process. Alternatively, the buyer can opt for a delayed closing of the sale, with court-approved restrictions on operations of the hospital during the pre-closing period.

Although there is no one-size-fits-all template for buying a distressed hospital out of bankruptcy, the process is designed to be flexible and can be tailored to accommodate the needs of the particular hospital and buyer.



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