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If You're Reading This, You're Too Late: Key Drivers in Rising Health Care Defaults

Authors: Timothy Lupinacci
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Health care bankruptcy filings more than tripled in 2017 as compared to 2016 with no end in sight to the financial struggles facing owners and operators in the sector. According to Bloomberg, health care bankruptcies have "surged 123% since the fourth quarter of 2010, compared to a decline of nearly 58% in the general index tracking commercial bankruptcy filings over the same time." The problem has been exacerbated by "hospitals, physicians, and other health care providers operating with thin profit margins with the prospect of reimbursement cuts, negative patient mix trends and softening volumes," a point noted by KeyBanc Capital Markets in its report, "*Are you Ready for the Future of Healthcare? (2018 Outlook)*."

Increasing financial distress is particularly true of health care providers in rural areas. At present, approximately 44 percent of rural hospitals operate at a loss, according to Becker's Hospital CFO Report. A growing number of health care companies "may face near-death experiences of their own [as a] wave of hospitals and other medical companies are likely to restructure their debt or file for bankruptcy in the coming year." The threat of higher borrowing costs comes as providers already face significant financial challenges, including a lack of sufficient cash flow, all of which will make bankruptcy more likely. In addition, "regulatory changes, technological advances and the rise of urgent care centers have created a 'perfect storm' for health-care companies."

The factors leading the health care industry into crisis are as varied as the types of services provided across the health care spectrum. The continuing uncertainty over the possible collapse, replacement or defunding of the Affordable Care Act remains a constant pressure on the industry, as does ongoing downward pressure on Medicare reimbursement rates. Companies also face the erosion of profitability due to the evolution from a "fee-for-service" payment model to a "bundle of services" payment model. Even against the backdrop of financially distressed operators, there is increased competition as lenders have reopened their coffers in more aggressive financing arrangements.

There remains pressure for increased investments in additional personnel, technology and upgrades for aging buildings, as well as increased pharmaceutical costs and rising wages. At the same time, these same operators face liquidity problems caused in part by delays or disputes regarding reimbursement from government and private payers, as well as the recoupment or setoff of overpayments. In addition, skilled nursing facilities (SNFs) are facing decreasing utilization for 21-day rehabilitation stays. All of these general factors, together with specific issues faced by particular providers, has resulted in a fire keg where any given owner or operator could find itself filing for bankruptcy protection to try to preserve value and the operation itself.

With the backdrop of the individualized nature of most financial distress situations, there are some macro-trends over the past couple of years, including an increase in the financial health of specialized health care providers. This includes sectors such as specialty outpatient facilities; long term acute care (LTAC) hospitals; SNFs; free standing emergency rooms; physicians' offices and clinics; home health care providers; community

health centers; cancer care service providers; neurology, neurosurgery and pain management providers; dialysis management providers; and labs.

A large part of the heightened problems for more specialized providers has resulted from ongoing uncertainty relating to reimbursements as particularized health care concepts mature into more established providers. A prime example is LTAC hospitals, where the United States Centers for Medicare and Medicaid Services (CMS) implemented new, more stringent LTAC patient criteria and reduced the reimbursement rate for non-qualifying patients receiving care at LTAC hospitals, changes that were implemented in September 2016 (although the enabling legislation was approved by Congress in late 2013). In addition, geography matters significantly in identifying trends, as providers in more rural areas are struggling financially in increasing numbers.

With the rise of health care bankruptcies over the past few years, there has been an increase in specific bankruptcy issues arising with the unique aspects of health care companies. Some of these issues are common to most Chapter 11 reorganization bankruptcy filings, but have subtle nuances given the health care overlay, including regulatory implications, patient care and litigation. This has led to increased litigation in bankruptcy over what jurisdiction and power the bankruptcy court has over CMS and other administrative and regulatory matters. This is really a fight about where to fight with payer disputes, including payer take-backs as setoffs or recoupment.

In addition, there has been an increased use of prepackaged bankruptcy plans to incorporate agreements with the government. These typically proceed with negotiating an agreement with the governmental agency involved and then incorporating the agreement into the reorganization plan to restructure other debts and obligations. If such a pre-bankruptcy agreement has not been reached, there is increased focus on litigating disputes with the government on reimbursements and other issues in the bankruptcy court.

There has also been a substantial increase of litigation in bankruptcy courts over substantive consolidation of health care enterprises in bankruptcy. Modern health care enterprises consist of multi-tiered, overlapping layers of complex corporate structures comprised of multiple layers of single-purpose entities. Often, these individual corporate entities are viable only within the framework of the greater corporate enterprise. Upon the filing of a multi-entity health care bankruptcy, the court must determine whether the corporate structure should be upheld, or whether the entities should be collapsed or substantively consolidated. The impact of substantive consolidation can be great as creditors of a single financially healthy entity becomes a small piece of the larger global entity financial distress. Given the current health care industry approach to corporate enterprises, and the industry's financial distress, substantive consolidation has grown in importance.

There are generally only two circumstances in which substantive consolidation has been found by bankruptcy courts to be appropriate: (1) where creditors dealt with the debtors as a single economic unit and did not rely on their separate identities, or (2) where the affairs of the debtors are so entangled that consolidation will benefit the estates of all of the debtors (i.e., where "untangling is either impossible or so costly as to consume the [debtor's] assets"). This is a uniquely fact-intensive analysis and is very costly to litigate on both sides.

A corollary issue that arises at a heightened level is the impact of health care lease structures under the Bankruptcy Code. While the lease provisions of the Bankruptcy Code apply generically across industries (with some specific exceptions), the increased use of related-party and third-party leasing increases the volume of leasing issues in health care bankruptcy cases.

Another litigation matter that seems to arise more frequently in health care enterprises is the ability to incorporate management and insider releases into the reorganization plan. This is of significant importance where allegations of breach of board fiduciary duties is called into question. Finally, the health care industry has taken extensive advantage of the use of the Bankruptcy Code "§363 sale" to acquire or divest distressed

health care assets. The ability to acquire assets "free and clear of liens" is a signature benefit of the Bankruptcy Code's sale provisions, although there are some limitations.

Given the increasing cracks in certain segments of the health care industry, particularly for specialized health care providers, players in the industry must stay alert to the financial health of owners, operators and providers. In addition, a working knowledge of your rights and remedies in bankruptcy is critical to navigating these uncertain waters.