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"Jagged Little Pill": Substantive Consolidation in Health Care Insolvencies

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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.[1] 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."[2] These bankruptcies include hospitals, physicians' offices and clinics, specialty outpatient facilities, assisted-living and nursing home operators, and other providers. The problem has been exacerbated by health care providers operating with thin profit margins with the prospect of reimbursement cuts, negative patient mix trends, and softening volumes.

With the rise of health care bankruptcies over the past few years, there has been an increase in 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.

One such issue that has seen an increase in litigation is the 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.

If substantively consolidated, the court will examine the global enterprise as a whole, consolidating all assets and liabilities regardless of the entity serving as the source of same. The impact of substantive consolidation can be great as the claims of creditors of a single financially healthy entity become a small piece of the larger global entities' 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 two circumstances in which bankruptcy courts find that substantive consolidation is appropriate: "(i) whether creditors dealt with the debtors as a single economic unit and did not rely on their separate identity in extending credit . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors (i.e., where 'untangling is either impossible or so costly as to consume the [debtor's] assets'").[3] This is a uniquely fact-intensive analysis and is costly to litigate on both sides. Factors that courts tend to evaluate include (1) whether the debtors' cash is concentrated at one entity that pays the entire enterprise's expenses, (2) whether all entities have the same officers and directors, (3) whether subsidiaries are wholly owned, (4) whether contracts are typically entered into by a single entity on behalf of the enterprise, (5) whether a single entity employs all employees, (6) whether financial statements and tax returns are completed on a consolidated basis, (7) the extent to which the entities are obligors on the same secured credit facility, (8) whether the secured lender only requires consolidated reporting, and (9) whether substantive consolidation is consistent with the enterprise's business operations.[4] Some

bankruptcy courts even use substantive consolidation to consolidate the debtor with *non-debtor entities*. An early example in a health care case is *In re New Center Hospital*,[5] in which the bankruptcy court substantively consolidated the debtor's assets with the assets of several non-debtor affiliates. The bankruptcy court reasoned that the affiliates were the alter egos of the debtor.[6]

Health care facilities tend to be structured in such a way that substantive consolidation may be appropriate. For example, let's assume that Wonderful Neighborhood Care, Inc. is the holding company for five local urgent care facilities operating under the same trade name, "Wonderful Neighborhood Care Clinic." In actuality, each of the five locations may be owned or leased by a separate real estate holding subsidiary, e.g. "Wonderful Care Northside RE Holdings, LLC," "Wonderful Care Southside RE Holdings, LLC," etc., but those real estate companies may own no other assets other than the facility and associated equipment and fixtures. The real estate companies may sublease or contract with the affiliated operating company, "Wonderful Neighborhood Care Operating Company, LLC," to actually operate the facilities, collect receivables, and pay expenses on behalf of all of the entities. Finally, separate entities might be used to hold discreet assets, like intellectual property or employ doctors or other professionals.

The expenses of all of these entities would be paid by the operating company. Furthermore, it is likely that any working capital lender of the operating company would require a security interest in all of the assets of each entity as well as guaranty agreements from all of the other entities. Thus, for purposes of the substantive consolidation analysis, the major trade, secured, and tax creditors are all dealing with the same entity—the operating company—which controls all of the enterprise's cash. Furthermore, as single-member LLCs, all would be disregarded entities for tax purposes and would file a consolidated tax return at the "Inc." holding company level.

On the other hand, distinct lenders or trade creditors may become involved in some, but not all of the related entities. This is particularly true in the case of a multi-jurisdiction enterprise. Given that the lender, or trade creditor, made credit decisions based on one or more entities, but less than the whole, substantive consolidation with multiple other entities could significantly impair and undermine the creditor's business relationship with its customer, the creditor could be forced into a much-diminished position given the consolidation with other companies and creditors on which it did not base any of its decision making.

One recent case that dealt with substantive consolidation in the health care industry is the bankruptcy case of Adeptus Health, Inc. and its subsidiaries.[7] Prior to filing its chapter 11 case, the Adeptus enterprise operated 99 free-standing emergency rooms and five full-service hospitals spread over three states. The bankruptcy court in Adeptus approved the debtors' plan to consolidate, for purposes of plan voting and distribution, the estates of 140 debtors in an opinion issued on September 29, 2017.[8] The consolidation of entities was hotly contested not only by the equity committee initially, but also a trade creditor who had provided significate services to a portion, but not all, of the debtor entities. It faced the very real challenge that consolidation would diminish its ultimate recovery.

Several facts convinced the court in the *Adeptus* case that substantive consolidation was appropriate. The court noted in particular the sheer number of debtors—140—made the case unique and greatly increased the cost of separating each debtor's assets and liabilities. Furthermore, 80 of the debtors were guarantors on the same prepetition secured credit facility (the remaining 60 had little or no assets), and all 140 debtors were obligated on the postpetition debtor-in-possession financing. All debtors had the same officers and directors, who operated and controlled the debtors from a single headquarters. The court noted that the testimony indicated that the debtors' books and records were a "tangled mess" since they paid all of the bills out of a single cash management system, kept consolidated books, and filed consolidated tax returns and financial statements. Finally,

all of the debtors had joint claims against officers and directors, which would form the primary asset of the post-confirmation litigation trust that the chapter 11 plan set up to pay creditors.

Similar issues were raised in the Louisiana case of *In re Acadiana Management Group, LLC*[9] involving 14 post-acute care hospitals. The debtors proposed a plan of reorganization providing for the substantive consolidation of all assets (and all proceeds thereof) and liabilities of the various debtors to be treated as though they were merged into and with the assets and liabilities of each other. The plan also provided for the extinguishment of all intercompany claims, and that all guaranties executed pre-bankruptcy by the debtor companies of other debtor's obligations would be deemed eliminated. The plan provided that all claims filed in any of the chapter 11 cases would be treated as filed against the consolidated company, including for determining the availability of the right of set off. In support of the consolidation, the debtors cited the factors from the *Adeptus* decision. Initially, various parties objected to substantive consolidation, including the Official Committee of Unsecured Creditors; however, the various constituents negotiated an amended plan that did incorporate substantive consolidation.

Substantive consolidation is not just for large corporate enterprises. An Ohio bankruptcy court entered an order substantively consolidating limited liability companies with two individuals in their chapter 7 bankruptcy case.[10] The *Felix* case involved home health nursing care services operated by one or more LLCs over a period of years. The couple's bankruptcy filing "unmasked a maze of business, financial transactions and family ties so complex that the [bankruptcy trustee] seeks substantive consolidation as the only practical means to provide a potential recovery."[11] The court was persuaded by uncontroverted evidence that the individuals used LLC accounts to fund daily living expenses, from mortgage payments, doctor visits, and health club memberships to shopping trips, airline tickets, and hotels. The parents also purported to sell the LLC to their son in further disregard for the interests of creditors. Further, the parents' formation of multiple entities across several states with an imprecise use of names and corporate records made it virtually impossible to trace and unravel transactions through less invasive measures than substantive consolidation, such as fraudulent conveyance litigation.

As a result, the court in *Felix* consolidated all assets, interests, and liabilities of the home health LLC with the couples' bankruptcy estates together with any other entities or persons through which the individuals ever conducted business. While this may appear an extreme remedy, it can prove effective for closely held health care providers subject to less stringent regulatory oversight such as existed in this case.

Substantive consolidation, while remaining an extraordinary remedy in bankruptcy cases, is an important avenue of attack for health care creditors facing significant losses in a provider insolvency. The concepts have been increasingly litigated and applied in the health care bankruptcy sector where multi-level mazes of LLC structure have been put into place to shield a corporate enterprise from liability of one operator. However, the concept is not limited to larger health care companies, as closely held companies of varying size and breadth are also potential targets of consolidation that will enable vendors an increased recovery. Litigating substantive consolidation is a costly exercise; however, if vendors left holding the bag from health care providers can work together to share costs, it can be an effective avenue of attack to secure more return on the defaulted accounts.

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Endnotes

[1] Tiffany Kary, *Next U.S. Restructuring Epidemic: Sick Healthcare Companies,*" Bloomberg, Nov. 27, 2017, *available at* https://www.bloomberg.com/news/articles/2017-11-27/next-u-s-restructuring-epidemic-sick-health-care-companies.

[2] *Id.*

[3] *In re Augie/Restivo Baking Co., Ltd.,* 860 F.2d 515, 519 (2d Cir. 1988).

[4] *See In re American HomePatient, Inc.*, 298 B.R. 152, 166 (Bankr. M.D. Tenn. 2003).

[5] 187 B.R. 560 (Bankr. E.D. Mich. 1995).

[6] *Id.* at 571.

[7] *In re ADPT DFW Holdings, LLC,* Case No. 17-31432 (Bankr. N.D. Tex.).

[8] *See In re ADPT DFW Holdings, LLC*, 574 B.R. 87 (Bankr. N.D. Tex. 2017).

[9] Case No. 17-50799 (Bankr. W.D. La. 2017).

[10] *In re Felix,* 572 B.R. 892 (Bankr. S.D. Ohio 2017).

[11] *Id.* at 893.

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