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EXPANSION BY THE ACQUISITION OF FINANCIALLY DISTRESSED HEALTH CARE FACILITIES AND COMPANIES: OPPORTUNITIES AND CHALLENGES

Market forces driven in large part by the Affordable Care Act ("ACA") require hospitals and health systems to build more comprehensive provider networks and to invest more heavily in the information systems necessary to manage care effectively. At the same time, these economic factors are driving down reimbursements from Medicare and other payors. For some hospitals and physician groups, these competing economic challenges may be too much.

In 2012, at least nine hospitals declared bankruptcy; five more did so in the first half of 2013.[1] Additionally, several hospitals and nursing homes are struggling to satisfy their bond covenants, and some hospitals are offering riskier securities to the marketplace.[2] Many independent physician practices are also struggling, with bankruptcy filings increasing for primary care physicians, oncologists, and cardiologists.[3]

These systemic challenges have led to a dramatic increase in merger and acquisition activity within the health care industry. *Modern Healthcare* reported 229 mergers or acquisitions during the second quarter of 2013, with a total dollar value of nearly $50 billion.[4] Financially stressed hospitals and physician practices present real opportunities for financially stable hospitals to expand provider networks and compete more effectively in the new era ushered in by the ACA, but distressed acquisitions also carry risks that must—and can—be understood and managed.

The following chart highlights several important issues that a hospital or health system should consider in deciding whether and how to proceed with the acquisition of a financially distressed entity:

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Issue	Outside Bankruptcy	In Bankruptcy
Purchase Price	The seller may be unwilling or unable to sell for a price less than its total debt even if that price is materially higher than the fair value of the business or assets—forcing a buyer to walk away from a desirable acquisition or to overpay.	Bankruptcy sale prices are typically determined by an open bid process—often for amounts less than the secured indebtedness—with the buyer generally taking the purchased assets “free and clear” of liens, claims and interests.
Fraudulent Conveyance	Purchasing from a distressed seller may expose the buyer to post-closing fraudulent conveyance claims. The outcome can depend on inherently uncertain factors such as whether the seller was insolvent or became insolvent as a result of the transaction and whether the buyer paid “reasonably equivalent value.” An appraisal offers some protection, but it is not ironclad and may not be available where assets are bought at a significant discount.	Bankruptcy court approval of a sale eliminates fraudulent conveyance risk. However, bankruptcy usually requires a formal bidding and sale process, with a chance that a buyer could be outbid. There are techniques to mitigate the risk and costs of being overbid, such as the buyer providing secured bridge financing, being designated as the “stalking horse” bidder with break-up compensation, or proposing a pre-packaged bankruptcy plan.
Successor Liability	A buyer may be held liable as the seller’s successor on a wide variety of claims, including environmental, product liability, tax, employee benefits, labor and employment, and fraud and abuse. A seller’s indemnification may mitigate that risk but may be worthless if the seller is insolvent.	Bankruptcy court approval of a sale can cut off many successor liability claims, although certain claims, discussed below, can survive under a variety of theories, including claims that present significant exposure such as environmental liability.
Labor/Union/ Pension Issues	A distressed business may have a variety of labor, union, and pension issues that can make it nonviable, including significant underfunded pension and/or retiree health care liabilities. Outside of bankruptcy, negotiations with labor unions and/or the Pension Benefit Guaranty Corporation may be required, and a buyer may have little negotiating leverage.	Bankruptcy offers several protections that can help resolve labor, union, and pension issues. The unilateral rejection of CBAs may be possible, which can create additional negotiating leverage for a debtor or acquirer. It is often possible to terminate an underfunded pension plan and shield purchased assets from any attendant liabilities. Even in bankruptcy, however, a variety of risks remain, including the potential for strikes.
Medicare/ Medicaid Overpayments	The government has authority to offset or recoup from, or suspend, Medicare/Medicaid reimbursements as a result of prior overpayments, which can severely disrupt a distressed business’s operation.	The “automatic stay” or other relief from the court may delay the government’s efforts to recover Medicare/Medicaid overpayments and create a better environment for a negotiated resolution with CMS.
Medicare/ Medicaid Provider Agreement Assignment	Federal regulations generally allow for the automatic assignment of Medicare provider agreements to a buyer, transferring to the buyer the seller’s liability for overpayment claims and compliance issues. To protect the buyer, the seller should disclose and resolve any overpayment and compliance issues before consummation of the transaction, which may prove difficult. The buyer may also rely on seller indemnification, although doing so offers little protection if the seller is insolvent.	Most courts have held that a buyer that assumes an automatic transfer of the seller’s Medicare provider number is liable to the government for all overpayment claims (as well as related civil fraud and abuse claims/penalties). On the other hand, some courts have treated a provider agreement as a noncontractual statutory entitlement (instead of as an executory contract), and hence as property that arguably could be sold free and clear of the overpayment liability. Bankruptcy may help bring regulatory officials to the negotiating table over these liabilities, particularly if a provider serves as a vital health resource for its community and no alternatives exist.

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Assignment of Commercial Payor Contracts	The terms of private payor contracts may restrict assignment by the seller, giving those payors significant leverage in a sale.	Anti-assignment provisions in private payor contracts are likely unenforceable in bankruptcy.
State Licenses	Transfers of state licenses and certificates of need are subject to various state statutes and regulations.	Transfers of state licenses and certificates of need remain subject to various state statutes and regulations, but a bankruptcy court may be able to prevent discriminatory treatment of a debtor/seller in certain circumstances, and regulators may be more accommodating when a provider is in bankruptcy and on the verge of economic failure and shut-down.
Fraud and Abuse Laws	Distressed health care entities may have significant liabilities under various fraud and abuse laws such as: the Federal Anti-Kickback Statute; the Stark law; the Civil False Claims Act; the Civil Monetary Penalties Law; and a variety of similar state laws. Various parties may bring enforcement actions under some or all of the fraud and abuse laws.	Distressed health care entities may still have significant liabilities under various fraud and abuse laws, but the "automatic stay" may delay enforcement in certain circumstances (although important exceptions exist for a state's "police" powers, in cases involving significant health and safety issues, and for criminal (rather than civil) fraud and abuse actions). Health care assets may be sold free and clear of certain liabilities under fraud and abuse laws, although exceptions may exist for a buyer that assumes a Medicare/Medicaid provider agreement, and such liabilities could complicate transfers of state licenses and certificates of need to a buyer.
Due Diligence	A distressed seller may seek to minimize or hide its problems, complicating due diligence efforts.	Bankruptcy disclosure requirements should reduce the risk that a seller will minimize or hide its problems. However, the expedited nature of many bankruptcy sales can hamper the ability to conduct complete due diligence.
Closing	Third parties can threaten to bring fraudulent transfer actions to derail a sale either pre- or post-closing. A seller could file bankruptcy prior to closing and reject the buyer's purchase agreement so as to subject the assets to a bankruptcy sale.	Sale will be subject to bankruptcy court approval, and a bankruptcy court may require a formal bidding, auction, and sale process where the initial buyer could potentially be outbid by rivals. A "stalking horse" bidder can negotiate for a variety of protections that can reduce (but not eliminate) the risk of being outbid. Post-closing, unless the bankruptcy court's sale order is appealed, the sale order becomes final and nonappealable 14 days after it is entered. Even if the order is appealed, and as long as that order is not stayed pending appeal, the reversal or modification of the sale order will generally not affect the validity of the sale. This provides buyers who have proceeded in "good faith" with significant certainty that the transaction will not be unwound.

Jones Day offers notable experience in all the legal fields necessary to master these and the other issues that can arise in the acquisition of financially distressed hospitals, physician practices, and other providers. Our bankruptcy lawyers—members of an insolvency and restructuring practice consistently ranked one of the best in the U.S. and in the world—work seamlessly with our equally highly ranked health care transactional and regulatory attorneys to assist our clients in understanding and managing successor liability issues, developing transaction structures and strategies that minimize the risks presented by distressed M&A transactions, and negotiating affiliations that allow our clients to develop the systems necessary to succeed in the current environment. We are able to draw on the broad and deep knowledge of colleagues in public finance, labor and employment, tax, real estate, environmental, and other areas of law that may be required to complete a successful acquisition.

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ENDNOTES

1 Bob Herman, "Christ Hospital in New Jersey Set to Exit Bankruptcy," *Becker's Hospital Review* (June 6, 2013), *available at* http://www.beckershospitalreview.com/racs-/-icd-9-/-icd-10/christ-hospital-in-new-jersey-set-to-exit-bankruptcy.html.

2 *See* Municipal Securities Rulemaking Board searchable filings at www.emma.msrb.org; *see* Kelly Nolan, "Hospitals' Debt Gets a Checkup," *The Wall Street Journal*, Aug. 9, 2012, *available at* http://online.wsj.com/article/SB10000872396390444900304577579360896916848.html.

3 *See*, e.g., Parija Kavilanz, "Doctors Driven to Bankruptcy," *CNN Money*, *available at* http://money.cnn.com/2013/04/08/smallbusiness/doctors-bankruptcy/index.html.

4 *Modern Healthcare*, "Healthcare M&A Watch," *available at* http://www.modernhealthcare.com/article/20130720/MAGAZINE/307209970.

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