

Navigating Financial Distress

Troubled hospitals can be stabilized with immediate, transparent actions

By Richard J. Zall

Hospitals operate in an increasingly complex and challenging economic environment. In spite of these difficult financial times, however, hospitals can overcome financial Armageddon if they recognize the need for a turnaround soon enough and adopt a realistic action plan. While bankruptcy reorganization is frequently necessary at financially distressed hospitals, depending on the depth of the organization's problems, it is not required in all instances.

Hospital boards and senior management must play a critical role in implementing proper mechanisms to avoid an irreparable crisis that could lead to the closure of the hospital. Before financial distress spins out of control, leaders must devise strategies to quickly identify and remedy poor financial performance. To craft a turnaround plan, the board and senior management should:

- diagnose the extent and causes of financial distress;
- develop realistic restructuring options;

- identify and understand key business and legal issues associated with restructuring;
- learn from successful strategies already employed within the industry.

Identify the Problem

In business, as in life, sometimes the most difficult task in problem solving is admitting that a problem exists. A fully engaged board should be able to spot signs that the hospital may be facing serious trouble before a crisis develops. Active boards watch key financial metrics and trends, and they work with the chief executive and financial officers to develop and review realistic revenue and expense projections.

The burden of identifying the onset of serious financial distress rests with senior management. While it can be difficult for a CEO or CFO to admit that there are financial problems they cannot solve on their own, this step is critical. Boards should encourage senior management to come forward with financial distress warning signs without fear that they will be punished for sounding an alarm.

Once management and boards at financially troubled hospitals understand that business as usual cannot continue, they must analyze the root cause of the financial distress, isolating the specific sources. Common problems include: inadequate government or commercial reimbursement rates, broken revenue-cycle management, unsustainable debt-service payments, and deteriorating physician relationships that are causing reduced referrals and admissions.

Senior management and boards obviously should be assessing these and other key questions on an ongoing basis. But, when an organization's finances decline, they need to be addressed with increased vigor, speed and clarity. At the conclusion of this baseline analysis, the board should be able to articulate the three to five key elements that must be changed to stabilize the hospital's finances.

Communicate with Constituents

After diagnosing the problem, many hospitals suffer in silence; some don't inform key constituents even after the

problem is recognized. Management and the board must communicate a clear, consistent message regarding the nature and causes of their distress to key constituents who can help to develop solutions.

Most hospitals have the same critical constituents: medical staff; workforce (often represented by unions); vendors; lenders; and the communities they serve. It is important to be open and transparent with these stakeholders, and it is usually possible to do so without creating a crisis atmosphere. Those who succeed do so by clearly communicating the root causes of the hospital's problems and describing a realistic plan of action.

Most constituents will be asked to sacrifice. For example, employees may be asked for wage or benefit concessions, vendors and lenders may be asked for delays in payment or altered payment schedules, and medical staffs may have to defer equipment purchases. While these are never easy conversations, key constituents must know what is required and, most importantly, that the sacrifice is being shared.

Communications should extend to community representatives who depend on the hospital's services. Local associations whose members may face service reductions should be informed of the problems and the hospital's action plans. Elected officials play an increasingly significant role in the oversight of hospitals, and government regulators are often in a position to award financial grants and reimbursement enhancements to hospitals that face financial crises. That said, candid conversations with these stakeholders can prove invaluable.

Explore Restructuring Options

Boards and senior leaders need to consider the full range of restructuring options, which, in the context of this discussion, does not refer to a formal petition for bankruptcy and reorganization. Rather, while restructuring may need to include those actions, it can be accomplished through the development of a management plan to turn around opera-

tions, improve financial performance and strengthen the balance sheet and cash flow, without turning to bankruptcy court protection.

Most hospital turnaround plans have similar ingredients. Five common elements are:

- operational improvement;
- debt and contract restructuring;
- governmental assistance;
- sale of non-core assets;
- strategic affiliations, merger or sale.

Some of these actions can be implemented in three to six months, while others require more time to take hold. Usually, both varieties are needed. Troubled organizations need both financial relief that will avert an immediate crisis, and actions that will result in long-term repositioning.

In the short term, for example, a hospital can use revenue-cycle improvement, rescheduling and deferral of vendor and lender payments, staff reductions, and government assistance programs to improve its cash position.

Revenue-cycle improvement refers to the process of submitting claims, billing patients and collecting receivables. The revenue process can differ significantly across institutions, particularly with regard to the speed of the cycle. If an organization is struggling, one of the first improvements to make is reducing the time frame from billing to payment. Streamlining and improving this process can yield immediate benefits.

Vendors and lenders usually can be persuaded to restructure payment schedules if they understand the hospital's financial challenges, provided they believe the hospital has a realistic plan to address them.

Staff reductions are another short-term strategy to stabilize the organization. Unlike revenue-cycle improvements, staff reductions generally do not yield immediate financial gains because of severance obligations. However, when an organization's patient volume drops and contributes to a decline in revenue, it is critical to re-examine staffing levels,

and this action may produce material benefits in the near term.

In addition to these steps, hospitals should examine the availability of government-assistance programs that provide emergency fiscal relief, usually through grants or low-interest, unsecured loans.

To address more fundamental financial problems, hospitals need to probe other areas of opportunity. Hospitals often hire outside experts to assess whether their facilities are adequately paid for services rendered. They can address these disparities through third-party reimbursement appeals, renegotiation of managed care contracts, and the sale or disposition of non-core assets.

In combination with these actions, hospitals can seek to establish new affiliations or strategic alliances with other hospitals or health care entities. If none of these strategies leads to a viable stand-alone organization, then a sale or merger with a stronger health system may be necessary.

If the turnaround process does not yield tangible results quickly, a hospital may need to consider more dramatic restructuring options, including recourse to the bankruptcy reorganization process. In most bankruptcies, the debtor will continue to possess and operate the hospital, but it will do so under the protection of the bankruptcy court. As the board or management team assesses whether to go down the path to a bankruptcy filing, it is important to weigh the benefits against the costs. For instance, while the bankruptcy process provides protection from creditor actions to collect their debts, it also comes with costs — both monetary and intangible. Organizations that file for bankruptcy lose a measure of control because actions following a filing require court and creditor committee approvals, and there is sometimes a lingering stigma from having filed bankruptcy.

A pre-packaged bankruptcy, or out-of-court restructuring, is an alternative to a standard bankruptcy petition. In these circumstances, the hos-

pital seeks to persuade creditors to accept reductions that will allow the debtor to avoid bankruptcy, and the hospital can sometimes negotiate a sale of assets to another hospital and file bankruptcy with those arrangements already in place.

Confront Legal Issues

As the board and senior management establish and implement a turnaround or restructuring plan, they need to keep in mind several key legal issues:

Fiduciary duties: The state attorney general, Internal Revenue Service and various community constituents monitor the board's ability to meet

with the organization's interests. Conflicts can occur in the form of a relationship with a vendor or with another institution. In most instances, conflicts can be disclosed and managed effectively by having the interested director refrain from participating in certain deliberations and decisions.

Affiliated entity questions: In a health care system made up of multiple entities, there may be one troubled entity and sister entities that are doing fine financially. If a health system has a unified governance structure, it is critical for the board to evaluate each entity's interests separately. It is also important that transactions between

to evaluate the scope of the consultant's experience and to define performance standards with a critical eye. Officers, such as the general counsel, should be designated to oversee the restructuring consultant, to set reasonable payment terms and to maintain the ability to terminate the consultant if performance is inadequate.

Preference liability: Boards must maintain neutrality within classes of creditors. In particular, they must avoid preferential treatment to insiders. For example, a board member who is also an executive at a hospital vendor might be inclined to look for some preferential treatment. However,

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its fiduciary obligations. Specifically, the standard fiduciary duties of the board are a duty of care, a duty of loyalty and the duty to uphold the organization's mission. The board should carefully assess its options with these duties in mind and document its actions thoroughly.

Business judgment rule: This rule protects the board by shielding it from liability when a business decision backfires, as long as the board is suitably informed, asks probing questions about options being considered and alternatives, and makes the best business judgment possible under the circumstances. Boards do not have to be right; rather, they must be responsible custodians of the institution.

Conflicts of interest: It is very important for boards to identify trustees with actual or potential conflicts

and among entities are at arm's length and at fair market value. Also, funds should not be shifted from entity to entity without sound justification.

Staffing reductions and patient safety: As a troubled provider trims its debt and streamlines its assets, supplies and staffing will be cut. However, patient safety should remain a top priority in the exercise of the board's fiduciary responsibility. It is important to remember that a hospital's duty to its mission to remain open assumes the hospital can provide care responsibly.

Restructuring consultant: An institution in crisis often will contract with a restructuring consultant to assist with a turnaround. Some boards, when operating in an atmosphere of crisis, will fail to scrutinize consultants sufficiently. It is important

generally speaking, transfers to insiders out of the ordinary course prior to a bankruptcy filing could be considered improper preference transfers subject to being voided.

Embrace the Future

When hospitals begin to experience financial distress, boards and senior management should act quickly to identify the problem, develop a turnaround plan and communicate with stakeholders. With swift action, and a thoughtful examination of options, boards and senior management should be able to survive financial distress and safely guide their organizations to a more stable future. **T**

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