Proskauer

Diagnosing Distress: Top 5 Challenges for Private Credit Lenders in Health Care Restructurings

March 2, 2022

Despite the strength of the U.S. economy headed into the New Year, a variety of conditions may be conspiring against businesses in certain segments of the health care industry. These include reduced patient census at skilled nursing and other long-term care facilities, COVID regulations that limit the ability of providers to give (or patients to receive) various forms of treatment and patients choosing to delay lucrative elective procedures, or even to forego health and dental care altogether. In addition, Congress passed and President Trump enacted into law the No Surprises Act, which went into effect on January 1, 2022. This legislation will have a profound impact on health care service providers across the country. Each of these circumstances has inflicted severe revenue losses on health and dental service providers. At the same time, inflationary pressures, a health care staffing shortage and the consequent rise in payroll-related costs have showed no signs of abating. Making matters worse, Medicare reimbursement has been cut for many health care providers, although President Biden intervened in late 2021 to soften the blow for some. Finally, health care deals are facing greater antitrust scrutiny at both the federal and state levels with some states considering bills that would require parties to provide prior notice before a transaction.

Individually, or in combination, these and other adverse market conditions have the potential to wreak financial havoc on health care businesses. When financial distress afflicts one of its borrowers, private credit lenders must act quickly to maximize the prospects for recovering their capital. Discussed below are five of the most significant challenges for private credit lenders in addressing a distressed health care borrower.

1. **Time**

The need to act quickly in response to a loan default is not unique to health care lenders. Time is an especially valuable commodity in health care restructurings because of the time required to assess, formulate and execute a restructuring strategy. Structural complexities, change of control and licensing requirements and the necessity of patient care continuity, among others, can add weeks or months to the time required to successfully restructure or sell many health care businesses.

In our experience, health care restructurings have the greatest prospects for success when private credit lenders explore multiple strategic options simultaneously rather than sequentially. While a dual track or omni-track approach to any restructuring is more expensive in the short term, it can have a dramatic impact on a lender's loan recovery. For example, where shareholders are no longer supporting a borrower financially, lenders are well served by a "market test" for the sale of a borrower's business while simultaneously exploring a recapitalization transaction involving a debt to equity conversion. Using this approach, lenders will avoid being in a position where the sale process/market test has failed to identify an acceptable buyer (or price) and the lenders are forced to extend rescue financing to the borrower to afford themselves a chance to evaluate the feasibility of a change of control transaction instead of a liquidation. Of course, circumstances will differ in every situation, but private credit lenders are well advised to explore all potentially viable options at the first signs of trouble.

2. **Uncooperative Shareholders**

The second most significant challenge for a health care restructuring is inextricably related to the first: the uncooperative shareholder. Many private credit funds have deep relationships with sources of institutional capital. The collaborative nature of these relationships helps explain both the brevity and constructive tenor of restructuring activity during the early days of the COVID-19 pandemic. As the virus and its impacts have protracted, however, some shareholders have decided they are no longer able to justify additional financial support for their investments. When a shareholder is unwilling or unable to provide additional financial support to a company, and when that company will run out of money absent an injection of new capital, shareholders are often willing to relinquish ownership and control. This is particularly true where it is clear to all concerned that the shareholder's equity investment is worthless.

In these circumstances, why would a shareholder resist selling a troubled health care company or throwing the proverbial keys to the company's lenders when the lenders are willing to finance the business through a turnaround? From the standpoint of an incumbent lender, an uncooperative controlling shareholder can seriously jeopardize the prospects for loan recovery.

At the first sign of financial trouble, lenders should get a clear understanding about a controlling shareholder's willingness and ability to provide additional financial support. If the controlling shareholder is no longer willing to support the business, the lenders must have an even clearer understanding of whether the shareholders are prepared to sell the business or to transfer ownership as part of a debt to equity exchange, Article 9 foreclosure or other change of control transaction. While an uncooperative shareholder can be a problem in any defaulted loan situation, it poses a more serious risk in situations involving health care businesses primarily because of the time that may be necessary to effect a change of control and the amount of capital that may be required to sustain the company through that process. Stated differently, when an absentee, uncommunicative or uncooperative shareholder increases the time it takes to execute a restructuring strategy, the number of viable options available to lenders decreases, while the amount of capital needed to sustain the business through the restructuring process increases.

3. **Health Care Regulatory Hurdles**

Heavily regulated at both the federal and state level, health care businesses must abide by an ever-changing set of byzantine rules, regulations and guidance. For example, laws regulating the so-called corporate practice of medicine force capital providers to create complex deal structures that separate clinical from non-clinical assets and personnel. These highly bespoke organizational structures present financial and operational challenges during the best of times. When financial performance deteriorates, health care lenders find these structures particularly difficult to restructure or recapitalize.

For example, health care service businesses have wrestled for many years with various ways in which to partner with others to optimize service delivery and to maximize profit. With these objectives in mind, joint ventures were formed between health care service providers and other health care institutions including physicians, hospitals and long-term care facilities. In a series of public pronouncements and advisory opinions dating back to 2003, the Office of the Inspector General for the Department of Health and Human Services ("OIG") has found that various joint venture structures create significant risk of fraud and abuse in violation of the federal Anti-Kickback Statute (AKS). The heart of the OIG's concern are ventures that derive all or most of their revenue from referral by one joint venture partner to the other. For example, on November 17, 2021, the OIG issued Advisory Opinion 21-18. The OIG concluded that the proposed joint venture arrangement between a therapy services company and a company that owns skilled nursing facilities (SNFs), if undertaken, could generate prohibited remuneration under the AKS, "if the requisite intent were present." The OIG stated that its Opinion reflected its long-standing concern regarding joint venture arrangements, "especially where all or most of the business from the joint venture is derived from one of the joint venture investors." The OIG observed that the proposed arrangement presented "a host of concerns, including patient steering, unfair competition, inappropriate utilization and increased costs to Federal health care programs. Establishing a joint venture structure that passes muster with the OIG has proven elusive, and requires careful planning and solid execution.

Dealing with joint ventures in the context of a loan restructuring can present even greater challenges. First, a failed joint venture or one that falls outside of the ever-changing boundaries set by the OIG creates serious misalignment or friction between investors and lenders on the one hand, and providers on the other. Realigning economic incentives in the face of excessive leverage and operational stress is just one key element of a carefully designed restructuring strategy, one that consumes precious time and money. Joint ventures pose a structural challenges for lenders as well ***both*** at origination and in a restructuring. Ordinarily, joint ventures are partially owned subsidiaries of a health care borrower entity (which is often a management service organization). Where the borrower owns a minority of the joint venture, lenders can experience financial reporting and accounting problems as well as "runaway provider" issues when the provider/joint venture partner begins to experience the consequences of financial distress – anxiety that lenders are accustomed to dealing with but licensed health care professionals are not.

A more recent health care law, the No Surprises Act, could have a dramatic impact on the future financial performance of health care service providers and may trigger a substantial increase in loan defaults in certain sectors. The No Surprises Act adds regulatory requirements and protections designed to hold consumers harmless from the cost of unanticipated out-of-network medical bills. For example, out-of-network providers of emergency services are not allowed to "balance bill" patients beyond the applicable in-network cost sharing amount for surprise bills. With certain exceptions, this same requirement applies to out-of-network providers who render non-emergency services at in-network hospitals or other facilities. The No Surprises Act puts the burden on out-of-network providers to determine a patient's insurance status and the applicable in-network cost sharing amount for the surprise medical bill. Although the financial impact of the No Surprises Act is still playing out for health care providers, lenders are already seeing hardship for certain businesses such as air ambulance services and ancillary service entities that support hospital in-patient, out-patient and emergency operations.

The health care regulatory hurdles when delivering health care goods or services presents many challenges that can be difficult to overcome in the face of financial distress. As with an uncooperative shareholder, a rapidly-changing regulatory maze can cause serious financial uncertainty and take time to diligence, analyze and sort through in the context of a loan restructuring.

4. **Medicare Participation**

For many health care businesses, participation in the Medicare system is essential. Despite its financial significance, Medicare participation poses additional risk to health care lenders. First, Medicare receivables may not be pledged as collateral to a lender, yet another regulatory challenge that necessitates additional structuring and loan administration, normally through segregated collection accounts and daily sweeps. In addition, Medicare receipts are subject to audit and clawback or recoupment if an overpayment is uncovered. In the same vein, under the False Claims Act ("FCA"), Medicare claims that were submitted for payment when the provider knew or should have known that they were unsupported, false or fraudulent can be subject to fines up to three times Medicare's loss plus $11,000 per claim filed. In addition to the civil monetary fines under the FCA and Stark Law, there can also be criminal violations under a number of health care fraud and abuse-related federal and state laws. For these reasons, borrower compliance with Medicare and other health care regulations is critically important to a private credit lender. Poor compliance can jeopardize both the underlying business and the lenders' prospects for recovery of capital.

When financial distress pushes a borrower into bankruptcy, the ability to continue participating in Medicare presents an enormous challenges for lenders. In an article published by *Bloomberg Law* in 2020, we analyzed two judicial decisions that could have dramatically changed the strategic approach taken by health care lenders when their borrower experiences financial distress. The upshot of these two decisions is that Medicare participation is a statutory entitlement that may be sold in bankruptcy free and clear of prior liabilities – a groundbreaking change in the legal landscape. The government responded very forcefully to both decisions, however, making clear to anyone paying attention that it would not tolerate a world in which troubled health care business attempted to walk away from any debt owed in respect of its Medicare participation. The major players in both cases relented and neither of the court approved sale transactions was ever consummated.

Although these decisions offer a glimmer of hope to lenders who might want to acquire a borrower's business by way of credit bid in a section 363 sale in bankruptcy, that strategic option may be impractical in light of the government's posture. Without that highly powerful tool (*i.e.*, the credit bid), lenders must either accept what the market will bear if the business is sold immediately or pursue the more difficult and expensive path of reorganizing the borrower's business through a chapter 11 plan of reorganization.

5. **Non-Dischargeable Debts**

The Bankruptcy Code affords a chapter 11 debtor broad statutory power to limit and estimate claims without the protracted delay, expense and uncertainty that typically would accompany such litigation outside of bankruptcy court. Many financially troubled companies, therefore, leverage the threat of bankruptcy to induce creditor support for out-of-court debt modifications. In the case of health care businesses, however, liabilities arising under the False Claims Act, Stark and Anti-Kickback statutes pose unique threats because they are non-dischargeable in chapter 11.

For private credit lenders, while these liabilities may be difficult to identify during the underwriting process, they can materialize and escalate quickly. Whether the result of simple billing errors or overzealous marketing schemes, non-dischargeable debts of this kind can trigger a suspension of Medicare reimbursements or throw an otherwise profitable health care business into crisis, leaving private credit lenders with little or no time to react. Even though such liabilities may be unsecured and structurally subordinate to the rights of secured lenders, the combination of government recoupment rights and the potential for non-dischargeability in bankruptcy makes these debts far more serious in a health care restructuring compared with other garden variety claims. In essence, if these debts cannot be discharged in chapter 11, then they must "ride through" the balance sheet as unsecured claims that must be satisfied in the ordinary course. Predictably, this dilemma often gives secured lenders some pause before they agree to convert their debt to equity and underwrite a turnaround plan, especially given any settlement of the non-dischargeable debts will require meaningful cash dollars. Private credit lenders must try to identify these claims early on in their business and legal diligence, and assess how they can best address these liabilities in their contingency planning.

Conclusion

As private credit lenders deploy more capital in health care, they must be mindful of the many obstacles that must be overcome when a health care borrower experiences financial distress and default on their loan obligations. This is particularly true given the current headwinds facing the health care industry. Now, more than ever, it is important for private credit lenders and health care executives to recognize and understand potential signs of financial distress in order to avoid restructuring or insolvency.

Related Professionals

- **Charles A. Dale**
  Partner
- **Vincent Indelicato**
  Partner