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Seven Thoughts When Considering Troubled Hospital Deals.

Those who follow hospital and health system M&A activity know that the market has been "frothy." We all see the high profile, "sexy" deals that appear in the news headlines but, for every large deal, there are myriad smaller deals that involve rural hospitals, county hospitals and, sole community hospitals, many of which are struggling, often both operationally and financially. These deals, despite their size, often are strategically important for the involved parties and, due to the financial issues many are facing, extremely complex.

Below are seven thoughts relevant to the acquisition of, or affiliation with, troubled hospitals:

Cash is Often King: Often, one of the biggest hurdles to acquiring a troubled facility is the drain on cash it is experiencing. Generally, credit lines are maxed out and the hospital's bond rating is poor, making it difficult to borrow, especially if cash flow is anemic. This often puts deals in jeopardy because there is always the risk that the target will run out of money prior to closing. This situation may require the acquirer to agree to provide financing to the target hospital; doing so often requires negotiation with bond trustees or with senior lenders who will likely insist on strict subordination agreements, with no guarantee that the loans will ever be recouped or repaid. Care should be taken to carefully prescribe the use of the financing proceeds so that they are applied in the most effective fashion (as noted below, however, the antitrust laws still apply during the period between signing and closing, which limits the control the acquirer can exercise over the target's operations). The acquirer should be prepared to walk away from its loans should the transaction, ultimately, fail either because the target will not have the wherewithal to repay the loans and/or the loans will be deeply subordinated to senior indebtedness.

Diligence is Incredibly Important: It goes without saying that diligence in hospital deals is important, but it is even more so in the context of the acquisition of a troubled hospital. In our experience, struggling hospitals lack the resources to carefully monitor compliance or hire appropriate legal counsel; worse yet, some take aggressive approaches to their relationships with referral sources and reimbursement. The acquirer will generally inherit many of the liabilities of the target (including its Medicare and Medicaid reimbursement liabilities), and because (as described below) indemnification is financially impracticable or unlikely, most of these deals are, what we like to call "diligence deals;" the decision to acquire a troubled hospital is, and should be, premised upon the strength of, and results of, the acquirer's diligence efforts.

The Law Still Applies: Despite the fact that a hospital is troubled and its survival depends upon some sort of successful acquisition or affiliation, the parties must bear in mind that the various laws surrounding their existence, operations, and acquisition still apply. For example, the acquisition could be subject to state certificate of need laws, and will most certainly be subject to state licensure and registration laws, all of which are subject to statutory timing and waiting periods and can slow down the acquisition process. Depending upon the state involved, and how critical the hospital is to care in its community, it may be possible to seek local or state government intervention to accelerate these time periods, or expedite review. Moreover, and more importantly, the parties should keep in mind that federal and state antitrust laws apply, especially during the executory period (e., the period between signing of a definitive purchase agreement and closing). Often, in light of the precarious financial position in which a target hospital might find itself, there is a desire for the two parties to work together to start fixing problems even before the deal closes. While laudable, and something that would seem to make perfect sense from a business perspective, the parties are well advised to seek legal counsel to ensure that they don't engage in so-called "gun jumping," which can lead to per se violations of federal and state antitrust laws.

Peculiarities Relative to Government Health Care Entities: We've seen a number of transactions involving government health care entities, such as county hospitals or health care district facilities. The acquisition of, or affiliation with, these entities will carry its own set of issues. First, and foremost, many of these entities are subject to state open records, or "sunshine," laws such that certain meetings, or documents, relative to the proposed transaction may be subject to public disclosure and scrutiny. Moreover, approval of many of these transactions may require public notice and a public meeting. In addition, acquirers need to be sensitive to the fact that decision makers may include community members who sit on country or district boards, many of whom, while civic minded, may not possess strong health care business acumen and may be motivated by the "politics" or optics of the transaction. Finally, care must be taken to review state law to ensure that there are not specific statutes or rules relative to acquisition of governmental health care entities; for example, some states require that all employees of the target be granted the opportunity to stay or, or that the acquirer agree to satisfy all outstanding liabilities of the acquired entity, etc.In addition to the above, county/district hospitals often have loyal constituencies. The fate of these hospitals is often of great importance to the communities they serve. Thus, and this probably goes without saying, it is often vital that the acquiring entity have a good story to tell as to why the combination makes sense, and this story should revolve around maintaining or increasing the quality and continuity of care to the patients, along with helping the employees retain their jobs. It is important to remember that these facilities often hold a prominent place in the communities they serve and, often, are one of the largest employers. Thus, the story to be told should be compelling, Even more important is the story that will be, or should be, told in the event the transaction fails. Consistent, realistic communication is appropriate in these circumstances.

Deal Planning: Almost as important as the economic and regulatory aspects of trouble hospital transactions is the deal planning. We say this because, often, time is of the essence for some the reasons described above. Thus, we believe that in conjunction with diligence efforts, smart acquirers plan ahead to deal, on a timely basis, with issues such as union contracts, physician compensation that may need to be adjusted, leases and the like. Failure to adequately plan for the issues that may arise related to the above sorts of matters can significantly slow down a transaction, thus putting further strain on the target.

Bankruptcy as an Option: Depending, of course, on the circumstances, there may be some wisdom in considering the use of a bankruptcy proceeding as a means of facilitating a transaction. Depending upon the nature of the target hospital—non-governmental versus a a governmental entity—the bankruptcy proceeding may be subject to either Chapter 11 or Chapter 9 of the Federal Bankruptcy Code. The determination about which type of bankruptcy proceeding (Chapter 9 or 11) a particular hospital entity qualifies for can be fact intensive and complicated, so it should be conducted by experienced counsel at the earliest opportunity. The distinction can be significant because, as a general rule, Chapter 11 proceedings (non-governmental entity proceedings) are somewhat more predictable and provide more established mechanisms to protect a potential buyer of assets. For example, the common method of selling assets through the bankruptcy process involves the use Section 363 of Chapter 11 of the Code to sell assets free and clear of liens and encumbrances. Chapter 9 does not have an analogous provision, though the few courts to have considered the matter have allowed sales to proceed in Chapter 9 under applicable state law. Under Section 363, the proposed buyer can become a "stalking horse" bidder, whose proposed purchase must be made subject to higher or better bids at a court sponsored auction, though subject to certain types of court approved bid protections. Thus, the stalking horse bidder risks losing the bid despite its work and efforts. Moreover, while a Section 363 sale can allow certain liens, executory contracts and other liabilities to be avoided and/or renegotiated, the Centers for Medicare and Medicaid Services take the position that if the acquirer assumes the Medicare provider agreement of the target (which is a common approach in many of these transactions) the bankruptcy proceedings will not extinguish pre-closing Medicare liabilities or obligations, such as overpayment obligations. Another significant difference between Chapter 11 and Chapter 9 proceedings is the ability of a debtor under Section 363 to sell assets free and clear of most pension liabilities. Again, no analogous power is found in Chapter 9, though in the Detroit Chapter 9 case, the court did allow some modification of pension benefits, as part of a final plan of reorganization, not as part of an asset sale.

Alternative Strategies: Sophisticated acquirers are well counseled to consider strategies that may be alternatives to acquisitions. For example, depending upon the market, it may be smarter simply to compete against the struggling entity rather than trying to acquire it. The idiom “be careful what you wish for” might be apt in certain situations. There is often a mission-driven desire, on the part of the acquirer, to save a struggling system, which is understandable. However, if an acquisition puts the acquirer at risk, it is necessary to re-examine the thesis of the deal and whether or not it is simply smarter to help the population of patients and employees of the target by them with an alternative.

Although sometimes smaller and involving fewer dollars than hospital deals that make headlines, troubled deals are a fact of life in health care and carry with them their own sets of complexities. The above list of considerations is but a few that will arise.

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