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From Crisis to Opportunity: Distressed Health Care Deals

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At the tail end of the COVID-19 pandemic in 2021 and through the first quarter of 2022, the nation saw a record high number of mergers and acquisitions in the health care space.[1] The market has since cooled, and the aftereffects of the pandemic have set in: Interest rates have spiked to 15-year highs[2] and remain elevated; inflation reached 9.1 percent[3] but has since dropped to 3.2 percent as of July 2023; COVID-19 stimulus funds ceased; reimbursement rate increases fail to cover cost inflation; health care labor challenges continue; and we have seen an acceleration in the trend toward out-of-hospital care. These factors are putting pressure on business performance, cash flow, valuations and access to capital, resulting in an increased number of distressed health care companies and more limited turnaround options.

As these key drivers persist, distressed health care transactions are expected to increase. This presents a unique opportunity for strategic buyers in the market who can provide a lifeline to distressed health care providers. However, distressed acquisitions are typically complex, and time is usually of the essence, so professionals with deep industry expertise are needed who can bring creative solutions and a different mindset to mitigate the risks involved and to ensure the best chance of success. This article provides an outline of key issues and recommendations for facilitating successful transactions involving distressed health care companies.

Background: Key Factors Driving Distressed Health Care Markets

Margin and Cash-Flow Pressures

The COVID-19 pandemic had a profound impact on the U.S. health care industry. Throughout the first few years of the pandemic, "cash poor" providers had access to cash through COVID-related government programs like the Coronavirus Aid, Relief, and Economic Security Act, and they received waivers and extensions from lenders that provided a financial buffer to avoid restructuring alternatives. Not only did these sources of relief largely dry up by the end of 2022, but providers who received Medicare advances[4] were required to repay those advanced funds,[5] thus impacting cash flow.

In addition, labor costs per hospital discharge rose by 25 percent, pharmaceutical costs by 21 percent, and supplies by 18 percent between 2019-22.[6] The health care workforce was also hit hard by the "Great Resignation," with burnout, stagnant pay and pandemic-related stress prompting many to leave and not return.

As a result, profit margins have been squeezed and, in many cases, wiped out completely. For example, roughly half of all hospitals ended 2022 with negative margins due to increasing expenses surpassing revenue growth.[7] With limited cash reserves and an inability to pass on all of the cost increases, health care companies are suffering from margin compression coinciding with a fraying safety net as COVID-19 relief funds dry up.

Limited Strategic Alternatives

Despite being viewed as a "recession resistant" industry, the health care sector has encountered financial difficulties amid a weakening economy. In order to combat rising inflation, the U.S. Federal Reserve started increasing interest rates in March 2022. By August 2023, the federal funds target rate had reached 5.25-5.5 percent,[8] the highest target rate in more than 15 years — and it could increase further.[9]

Higher interest rates have increased the financial burden on health care companies, particularly those with high leverage and exposure to floating-rate debt, but the higher rates have also had other implications. Asset valuations are affected by interest rates, which has led to pricing uncertainty and a disconnect between buyers and sellers, thus

1 "Healthcare Services Report," PitchBook (2023), *available at* view.pitchbook.com/viewer/64fa4307d50c9c1f1c5f09fe?iid=64d6708fc69aa8edead6e77b (unless otherwise specified, all links in this article were last visited on Sept. 19, 2023).

2 Taylor Tepper, "Federal Funds Rate History 1990 to 2023," *Forbes Advisor* (July 26, 2023), *available at* forbes.com/advisor/investing/fed-funds-rate-history.

3 "Historic Inflation Rates: 1914-2023," U.S. Inflation Calculator (2023), *available at* usinflationcalculator.com/inflation/historical-inflation-rates.

4 COVID-19 Accelerated and Advance Payments paid by CMS in relation to the Public Health Emergency.

5 "Repayment of COVID-19 Accelerated and Advance Payments Began on March 30, 2021," MLN Matters/Ctrs. for Medicare & Medicaid Servs. (May 12, 2023), *available at* cms.gov/files/document/se21004.pdf.

6 Victoria Bailey, "Inflation, Labor Costs Will Increase Healthcare Spending by $370B," *Revcycle Intelligence* (Sept. 26, 2022), *available at* revcycleintelligence.com/news/inflation-labor-costs-will-increase-healthcare-spending-by-370b.

7 "2022 Worst Financial Year for Hospitals and Health Systems Since Start of Pandemic," Kaufman, Hall & Assocs. (Jan. 30, 2023), *available at* kaufmanhall.com/news/2022-worst-financial-year-hospitals-and-health-systems-start-pandemic.

8 Tepper, *supra* n.2.

9 "Healthcare Sector Bankruptcy Filings Surge in 2023, Trending to Triple the Levels of 2021," Gibbins Advisors, LLC (July 24, 2023), *available at* gibbinsadvisors.com/healthcare-bankruptcies-surge-in-2023-trending-to-triple-the-levels-of-2021.

resulting in fewer deals taking place. Access to capital has become more difficult, as lenders tighten credit requirements and increase the cost of debt. For companies in financial distress, the usual "self-help" solutions are much harder to access. Eventually, unaddressed liquidity shortages compel a restructuring solution or a sale transaction in order for the company to survive.

Health Care Bankruptcies on the Rise

The increase in financial distress in the health care sector is evident in recent bankruptcy activity. As of June 30, 2023, chapter 11 health care filings in 2023 for debtors with liabilities of more than $10 million are trending three times the level seen in 2021.[10] There were 40 health care bankruptcies[11] filed during the first six months of 2023, compared to 46 total filings in 2022. There were 13 large bankruptcy filings involving liabilities of more than $100 million in the first six months of 2023, compared to 15 filings in 2021 and 2022 combined.[12]

While chapter 11 activity in the hospital sector is only starting to increase in 2023, hospitals may be particularly vulnerable moving forward, especially rural and standalone hospitals. As of February 2023, 43 percent of America's rural hospitals had negative operating margins.[13] In states without Medicaid expansion, that number increases to 51 percent.[14] Since 2010, 141 rural hospitals have closed and another 453 are reportedly vulnerable to closure.[15] Even where hospitals are staying open, vital health care services, such as obstetrics and chemotherapy, are being reduced or eliminated to preserve viability.[16]

Distressed Health Care Transactions

Distressed health care companies can provide valuable opportunities for strategic buyers or investors. However, a distressed health care transaction is very different, and typical solutions to mitigate risk might not be available. The following are some key considerations and practical solutions in distressed health care transactions.

Factoring in the Compressed Timeline

Distressed companies typically have strained cash flow, thus expediting a sale timeline. For buyers, swift identification of the biggest risks and opportunities in diligence is key. Where there is insufficient time for robust diligence, a buyer should factor the potential risks into the purchase price. Typical remedies, such as indemnification or escrows, might not be available if the target's representations and warranties turn out to be inaccurate (or are not provided).

For sellers of distressed health care companies, re-trading of the agreed deal post-auction but pre-closing is relatively common, and measures such as qualifying bidders, requiring meaningful cash deposits and securing backup bidders can provide some risk mitigation. This risk is particularly apparent in health care facilities, where several months or years may be needed to transfer licenses or provider numbers and close a transaction. The additional time gives the buyer more information on how to price the deal, and with the passage of time comes negotiating leverage.

Engaging Key Constituents

In a typical acquisition, creditors are not actively involved. However, as a company enters the zone of insolvency, creditors' rights must be considered. It is important to identify and engage with the key constituents throughout the process to ensure that assets can be sold free and clear. It is here where there might be divergent interests between a secured creditor (looking to be repaid) and a company's board (looking to maximize return for all creditors and shareholders). The sooner these key constituents are identified and brought into the process, the easier it will be to get a deal finalized.

Keeping the Company Afloat Until Closing

Distressed companies often have insufficient liquidity to continue operating until closing. There are several options that companies may seek in order to allow them additional time, such as: (1) negotiating with a secured lender to grant permission to use replacement reserves to fund a transaction process; (2) obtaining consents from lenders for payment relief, rescue financing or debtor-in-possession (DIP) financing (in a bankruptcy proceeding); (3) temporary arrangements with a buyer to assume financial responsibility prior to taking ownership (*e.g.*, interim management agreements) or buyer interim financing, which requires identification of potential collateral and negotiations with current lenders (if the buyer interim financing seeks to prime the current lender's liens); and (4) public-interest funding from local or state governmental bodies to prevent the closure of vital health care facilities.

Pros and Cons of Acquisitions in Bankruptcy

The bankruptcy process provides a plethora of options to health care providers with some major benefits. Bankruptcy can provide for the forced assignment of managed-care contracts, which might not be permissible otherwise.[17] A debtor can reject unfavorable contracts and assign Medicare numbers that might not otherwise be assignable.[18] In a bankruptcy, liabilities are typically known, and a sale is free and clear.

If any post-closing disputes arise, the parties can return to bankruptcy court, providing an efficient forum for resolution. To support a sale process, a potential buyer can obtain stalking-horse-bidder protections, such as a breakup fee and minimum bid increments. DIP financing can provide the lifeline needed to get a sale completed. In addition, a bankruptcy court can compel a sale timeline (usually a minimum of 45 days) that might otherwise languish.

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10 "Healthcare Restructuring: Trends and Outlook: Analysis of Chapter 11 Healthcare Bankruptcies Since 2019," Gibbins Advisors, LLC (July 2023).

11 *Id.* Chapter 11 filings for cases in the health and medical sectors for debtors with recorded liabilities of more than $10 million, as reported by Gibbins Advisors, LLC.

12 *Id.*

13 Michael Topchik, Troy Brown, Melanie Pinette, Billy Balfour & Ana Wiesse, "Rural Health Safety Net Under Renewed Pressure as Pandemic Fades," *Chartis* (Feb. 7, 2023), *available at* chartis.com/insights/rural-health-safety-net-under-renewed-pressure-pandemic-fades.

14 *Id.*

15 *Id.*

16 *Id.*

17 *See* 11 U.S.C. §§ 363(f), 365.

18 *Id.*

continued on page 59

With increasing governmental and regulatory scrutiny around health care transactions and mergers, bankruptcy can be a useful forum to accelerate decision-making from those bodies (although not guaranteed). Bankruptcy does not come without drawbacks, however. The bankruptcy process is public and can be expensive. A business's value might diminish during the pendency of the bankruptcy. A bankruptcy sale process is subject to higher and better offers, which is a risk for buyers. Furthermore, a debtor needs sufficient assets to cover post-petition administrative costs and typically provide for some distribution to unsecured creditors. Lastly, there is limited recourse for a buyer against a bankrupt debtor.

Timing of the Bankruptcy Filing Is Important

It is best to have a simultaneous sign-and-close with a distressed company or minimize the time between signing and closing. This is not always possible with health care companies when there are pre-closing notice or licensure-filing requirements. If a target files for bankruptcy pre-closing, the purchase agreement could be rejected, and a potential buyer would be left with a meager unsecured claim in the target's bankruptcy case for damages. Closing an acquisition prior to the target's imminent bankruptcy filing also poses certain risks, and protections should be added to the purchase agreement to preserve certain buyer rights.

A party should minimize the executory nature of the purchase agreement so that it cannot be rejected. This agreement should include a strong integration clause so that all purchase documents are considered part of the same integrated transaction and cannot be bifurcated. The definitive agreements should prevent the target from taking positions in a bankruptcy proceeding contrary to those in the agreements. Lastly, the agreement should allow for setoff rights against any future payments owed to the seller (*e.g.*, royalties, earn-outs, etc.), which are secured claims in a bankruptcy proceeding.

Minimizing Fraudulent-Transfer Risk by Demonstrating Fair Market Value

Creditors who remain unpaid may have no recourse to recover their claims and may become litigious. Buyers may become targets in sales for less than a reasonably equivalent value. It is important for a buyer to be able to demonstrate that the purchase price was the fair market value. While this can be difficult in an expedited sale or where there is no market for the assets, buyers should consider obtaining a third-party valuation, an affidavit from a banker or broker relating to the marketing process for the assets, or a fairness opinion. While not conclusive, they are an indication of value at the time of sale and may provide strong evidence in defending a fraudulent-transfer claim.

Successor-Liability Considerations

While the law continues to evolve on whether provider agreements are statutory entitlements (allowing free-and-clear sales) or executory contracts (requiring assumption, assignment and cure) in the bankruptcy context,[19] there are other circumstances where a buyer might be deemed a successor to the seller's business despite explicit provisions to the contrary in the purchase agreement. For example, certain states provide that a buyer is automatically liable for any unpaid state taxes of a seller in an asset sale if the buyer does not obtain a tax clearance letter from the state taxing authority prior to closing.

Courts are also more likely to find that a "*de facto* merger" occurred in a distressed sale, because they will examine whether the sale was a way for the seller to avoid liabilities. These factors can be minimized by the seller ceasing operations, liquidating and dissolving as soon as legally and practically possible post-closing, and the buyer assuming the obligations of the seller that are ordinarily necessary for the seller to conduct its business uninterrupted. The goal is to clearly differentiate the buyer from the seller. A buyer should consider making a public announcement of new ownership that is separate and distinct from the seller, changing the name of the business, appointing new officers or relocating the headquarters of the business, if possible.

Other Risk Mitigators

Given that typical risk-mitigation options might not be available, there is a heightened importance on the diligence of a distressed target. Other ways to mitigate risk include negotiating pre-emptive releases with problematic constituents, obtaining written consents to the transaction, and obtaining representation and warranty insurance. If the sale is an equity sale, it is recommended that the company obtain releases from prior officers and directors so that the company does not need to potentially indemnify them in later director-and-officer-liability litigation.

Conclusion

While the ongoing financial distress of health care providers is expected to continue into 2024, a transaction can provide an opportunity for a distressed business to find a new "home" where it can thrive, and buyers can acquire assets for attractive prices. While these transactions do not come without risk, if properly mitigated with the guidance of expert professionals, the risk may be justified by the reward. abi

19 *See Borrego Cmty. Health Found. v. Cal. Dep't of Health Care Servs.*, Case No. 22-02384-LT11, Adv. No. 22-90056-LT (Bankr. S.D. Cal. Oct. 26, 2022) (ECF Nos. 65-66); *In re THG Holdings LLC*, 604 B.R. 154, 160-62 (Bankr. D. Del. 2019); *In re Verity Health Sys. of Cal. Inc.*, 606 B.R. 843 (Bankr. C.D. Cal. 2019), *vacated as moot*, 2019 WL 7288754 (Bankr. C.D. Cal. Dec. 9, 2019); *In re Ctr. City Healthcare LLC*, Case No. 19-11466 (KG) (Bankr. D. Del. Sept. 10, 2019) (ECF No. 681).