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Steward Health Ch. 11 Lifts Lid On PE In Healthcare

By **Clara Geoghegan**

Law360 (May 17, 2024, 8:10 PM EDT) -- Steward Health's $9 billion Chapter 11 has come under scrutiny from state attorneys general seeking to uncover why a once-rapidly growing hospital network ended up buried in debt, with authorities taking the unusual tack of turning a special eye toward its former private equity owner Cerberus Capital Management, experts told Law360.

A sign sits outside Holy Family Hospital, a Steward Health Care facility in Methuen, Massachusetts. In the wake of Steward Health's May 6 bankruptcy filing, state attorneys general in Massachusetts and Arizona have taken unusual steps to probe what role, if any, the hospital operator's private equity owner played in its insolvency. (Suzanne Kreiter/ The Boston Globe via Getty Images)

The hospital network had been under the microscope in recent months **as professionals**, its **lawyers** and a **staffing agency** claimed it was millions of dollars behind on invoices. In February, the congressional delegation from Massachusetts, all Democrats, **sent a letter grilling** Cerberus on its management and profits when it held a majority stake from 2010 through 2020. Cerebus sold Steward to a private physician group in 2020 for $350 million.

Pressure has ramped up since the petition, as attorneys general in Massachusetts and Arizona announced plans to investigate and possibly intervene **in the Chapter 11 case**. Attorney general involvement isn't uncommon in bankruptcies where healthcare transactions need to be approved, but probing the circumstances that triggered insolvency is rare, experts said.

"Attorneys general in healthcare do get involved. But I haven't seen, in my experience, attorneys general stepping in to launch investigations related to the reason a hospital filed bankruptcy," said Clare Moylan, co-founder of healthcare operations and restructuring firm Gibbins Advisors.

Carolyn Johnsen, a bankruptcy attorney with Dickinson Wright, added that the public announcements of the investigations stand out.

"I've never seen [attorneys general get involved in a healthcare bankruptcy] to this extent; that doesn't mean it doesn't happen," said Johnsen.

Authorities have been keeping some details of their investigation close to the vest, but during a press conference on May 6, Massachusetts Attorney General Andrea Campbell hinted that whether Cerberus' management set Steward up for failure is one of the primary concerns.

"I also want to make it crystal clear, I take it very seriously, any effort for this hospital system to make a profit to the detriment of patients, to strip-mine hospitals for their value," said Campbell. "If those efforts have violated the law, those involved will absolutely hear from our office."

Campbell's office filed a limited opposition and brief in the Chapter 11 that alleged Cerberus' management squeezed Steward for profits and set it up for insolvency.

Arizona Attorney General Kris Mayes on May 10 announced her office was also opening an investigation into Steward's Chapter 11 and may intervene in the bankruptcy and planned sales of four hospitals in the state.

Founded in 2010, Steward runs 31 hospitals in Arizona, Texas, Arkansas, Louisiana, Massachusetts, Ohio, Pennsylvania and Florida. Chief Restructuring Officer John R. Castellano in a first-day declaration said it sought Chapter 11 due to the COVID-19 pandemic, a competitive labor market and lagging government reimbursement.

Steward's largest debt stems from a 2016 leaseback deal that saw it sell its hospitals to real estate investment firm Medical Properties Trust Inc. and locked it into a rental agreement until 2041. Steward owes roughly $6.6 billion in unsecured debt to MPT, which is also a secured prepetition creditor and **its debtor-in-possession lender**, according to Castellano's declaration.

Ashvin Gandhi, an assistant professor at the UCLA Anderson School of Management who has researched the impacts of private equity on nursing homes, said leasebacks are a common strategy private equity firms use to boost returns in healthcare and other industries.

While his research has found both good and bad outcomes for workers and nursing home residents after acquisitions, Gandhi said the strategies private equity firms often deploy to increase profits, like leasebacks, can leave a company financially and operationally vulnerable.

"Taking on a large amount of debt creates a different set of incentives for managers because they need to grow at a rate that justifies the incredible debt and to service that debt," said Gandhi. "It may cause them to be willing to take on certain types of risks to increase profitability that maybe other managers under less financial pressure wouldn't necessarily undertake."

The Massachusetts congressional delegation in a February letter to Cerberus criticized the leaseback and other business decisions made while it owned Steward, saying Cerberus raked in $800 million of profits while leaving the hospital operator deep in debt.

Cerberus did not respond to a request for comment but in a statement released in April defended its management of Steward.

"During our nearly 11-year ownership of Steward, we supported the revitalization of failing community hospitals into a leading healthcare system," said Cerberus.

On Thursday, Massachusetts' House of Representatives passed a bill to increase state oversight of private equity-owned healthcare facilities that was inspired by Steward's downfall. H. 4643, which was sent to the state Senate for consideration, would increase financial disclosure and reporting requirements for medical facilities and look to prevent future hospitals from concealing money troubles from regulators.

Sabrina T. Howell, a finance professor at the New York University Stern School of Business who has studied the impacts of private equity on stakeholders in a range of industries, said private equity acquisition in healthcare has grown rapidly in the past couple of decades.

Private equity reads off a similar playbook across industries, Howell said, acquiring and combining smaller companies, making operations more efficient, and taking on new debt obligations to boost returns, a step called financial engineering.

"I think the PE model can work, even in the long term, for consumers and other stakeholders in industries where incentives are well-aligned. But when you have an incentive alignment problem, then I think financial engineering in particular can lead to bad outcomes for consumers and taxpayers," said Howell.

Spokespersons for the Arizona and Massachusetts attorneys general declined to speak about the status or direction of the Steward inquiries, saying it was an open investigation.

Dickinson Wright attorney Johnsen said it's likely too early to predict what role the attorneys general will play in Steward's bankruptcy. While both have pledged to look out for patient interests and open investigations, Johnsen said they could take a step back from the case once the Office of the U.S. Trustee appoints a patient care ombudsman, a standard move in healthcare bankruptcies, or if Steward's recently appointed official committee of unsecured creditors opens its own investigation.

"Whether they take a backseat approach once [the U.S. trustee's ombudsman motion] finally gets filed, that just depends on the AG," said Johnsen. "They may be willing to take more of a backseat once the creditor committee gets up to speed and they see that the committee is protecting everybody's rights."

A spokesperson for Steward did not immediately respond to a request for comment.

The case is In re: Steward Health Care System LLC, case number 4:24-bk-90213, in the U.S. Bankruptcy Court for the Southern District of Texas.

--Additional reporting by Rick Archer, Jade Martinez-Pogue, Julie Manganis and Spencer Brewer. Editing by Philip Shea.