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Bankruptcy Sets Stage For Big Healthcare Buying Frenzy

By **Vince Sullivan**

Law360 (April 19, 2024, 5:17 PM EDT) -- The recent surge of healthcare bankruptcy cases has created an environment where Chapter 11's unique rules make it a prime vessel for larger enterprises to gobble up the foundering healthcare businesses of a post-pandemic world, experts say.

Healthcare companies are increasingly acquiring the assets of their smaller, debt-ridden competitors through Chapter 11, as the sector faces headwinds from higher interest rates and staffing costs, as well as lingering supply chain woes. (iStock.com/Sensay)

Able to better withstand the pressures of rising interest rates, soaring labor costs and dwindling revenue, large healthcare businesses like regional hospital systems are uniquely perched to take advantage of bankruptcy rules that allow purchases of debtor assets free and clear of existing liens.

"The size of a system definitely has an impact," Clare Moylan, a principal of healthcare advisory firm Gibbins Advisors, told Law360. "In the last 15 years, there has been a huge amount of consolidation in the healthcare sector where hospital systems have become mega hospital systems in order to have the scale that gives them huge advantages."

Rules unique to bankruptcy that facilitate sales free and clear of debts provide a landscape where that consolidation can continue.

State Of The Industry

Flush with pandemic relief cash, healthcare enterprises largely survived the era of widespread COVID-19. According to a report by Gibbins Advisors, 2023 was the busiest year for healthcare restructuring since 2018, and that upward trend is expected to continue for the foreseeable future.

As with just about every other business in the world, rising interest rates have crunched cash flow for healthcare players the last few years, and relief is not in sight. The cost of capital has risen at a time when revenue is not keeping up, leading to strains on liquidity industrywide.

Staffing costs have likewise skyrocketed in recent years, adding to the costs businesses must absorb to stay competitive. In the healthcare sector specifically, filling gaps in the workforce with contracted staff members is a costly necessity.

Lingering supply chain issues from the pandemic have also increased costs for healthcare entities and made it more difficult to obtain needed supplies and equipment.

All these drains on cash reserves have combined to send more healthcare companies in search of restructuring options than immediately before the COVID-19 pandemic. Hospitals and others were inundated with federal support during the outbreak of the coronavirus, which helped keep them afloat at a time when their services were in critical and elevated demand.

This confluence of economic factors has left smaller businesses shackled with higher costs at a time when revenue is not as strong for them, and larger players with larger cash reserves are able to ride through the distress.

"Larger organizations that have the benefits of scale are better equipped to weather this perfect storm of an inflationary environment with rising interest rates and labor shortages," Eric Walker of Cooley LLP said.

These smaller businesses include rural, community hospitals and small, specialized practice groups, which were already targets for consolidation before the pandemic and the current environment.

"Through the back end of 2023, some hospitals have started to recover, but it's really a tale of two different stories where the larger systems have big balance sheets, and more reserves when it comes to cash and invested assets," Moylan said.

Improvements in the stock market and more leverage when negotiating with payors have led to incremental revenue increases that have staved off distress for the big guys, she said.

Distressed Sales Opportunities

When a healthcare business can no longer meet its obligations, often a sale of assets will be the best path forward, and bankruptcy is an attractive option to complete such a transaction. Chapter 11 of the bankruptcy code provides the opportunity to sell assets free and clear of existing liens and encumbrances, opening a window for small businesses to market themselves to larger, better capitalized players.

Acquiring smaller enterprises such as a community hospital or a discipline-specific practice group can serve as an opportunity for a hospital system to increase its footprint or offer additional services as part of the hub-and-spoke model of healthcare that is increasing in popularity.

Rather than having a huge, single facility, many health systems are embracing that model, with a centralized location coupled with smaller facilities for specialized services spread throughout a region.

This method of expansion can lead to regulatory concerns, however, and the Federal Trade Commission and some state health and human service agencies have taken a particular interest in limiting regional monopolies.

"A sale that makes sense in bankruptcy may still have to go through the state attorney general's approval," Judith A. Waltz of Foley & Lardner said. "Somebody may think they're buying something at a good price, but the regulatory hurdles make it too expensive."

In bankruptcy, healthcare providers also run into obligations to ensure the level of care being provided by a debtor doesn't slip so that patients suffer. All of these added regulatory hurdles can add time and, more importantly, cost to an acquisition.

"The regulators regrettably don't always operate with the same sense of urgency required by the liquidity constraints of a debtor," Walker said.

But the upside to a bankruptcy acquisition comes with the benefit of the "free and clear" language of the bankruptcy code that lets a debtor offload assets to a buyer without the burden of liens or other obligations.

With this tool in hand, a regional hospital system can make an offer for a smaller entity, something like a specialized practice group of a dozen doctors focused on a specific area of medicine, and fold it into its larger footprint. It can do this without worries about carrying over any structural problems with the debtor's balance sheet or contractual landscape.

"It can increase the portfolio of services to provide to customers," Walker said. "They see it as an opportunity to grow their platform and create even better economies of scale."

Sale Or Bust?

Mergers and acquisition deals are not the only path forward for a distressed entity, though. Chapter 11 still creates an environment where a healthcare business can reorganize by shedding burdensome contracts, dealing with real estate obligations or swapping out debt for equity.

"It doesn't necessarily mean the end of operations. Chapter 11 can be an opportunity to streamline or to reorganize," Judith A. Waltz of Foley & Lardner said. "It really is an option that is a good thing to have. It's a safety valve in many respects."

A healthcare debtor is not immune to the normal stresses of operating in a competitive industry, and fundamental flaws in its operations can be rectified through bankruptcy. The flood of pandemic relief funds masked many of these flaws and allowed otherwise distressed businesses to continue operations as normal for a few years longer than they otherwise would have been able to do.

"Most people in the healthcare space saw that a lot of entities that probably should have filed before the pandemic were able to withstand the financial distress they were suffering because the government was essentially handing out a lot of checks," Carolyn J. Johnsen of Dickinson Wright said. "They were not then addressing whatever their financial issues were. They could have been management problems or vendor problems."

An issue unique to the healthcare industry is its dependence on third-party payors for services. A healthcare company provides the service to its customers, but more often than not, the customer is not the one paying the bill. Insurers and government agencies are usually the ones cutting checks, and problems with getting payment or complying with government regulations are one of the biggest administrative challenges facing players in this space.

Onerous contract obligations can also stymie the success of a healthcare provider, and bankruptcy provides an opportunity to get out from under those types of deals through the rejection process.

Future Trends

The problems facing the industry are unlikely to abate in the near term, and some trends in the industry will continue.

As an example, senior living facilities began struggling mightily during the pandemic as those businesses and their residents became particularly susceptible to COVID. New client admissions declined almost overnight in early 2020, and a return to normalcy in those statistics has not yet been seen.

Walker said many of the existing facilities were built quickly to keep up with the "silver tsunami" of an increasing client base of aging Baby Boomers, and now the buildings themselves are aging, requiring increased maintenance costs. At the same time, the generational demographics that called for that rapid construction are changing just as rapidly in the opposite direction. A shift in preference to at-home care has also led to a decreased demand for senior living facilities.

"We have been very busy working on a variety of senior living communities that are in various stages of financial restructuring," Walker said. "We see a pretty robust pipeline of senior living restructuring we expect will continue for the next 18 to 24 months, and probably beyond that."

--Editing by Peter Rozovsky.