

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

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The Sale of Nonprofit Hospitals through Bankruptcy: What BAPCPA Wrought

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According to many experts, the Patient Protection and Affordable Care Act² promotes the consolidation of the hospital industry.³ Many health care industry consultants believe that smaller, stand-alone hospitals will be forced to merge with larger hospital systems to survive. A significant percentage of America's hospitals are nonprofit hospitals,⁴ and those hospitals—if stand-alone facilities—are significantly weaker financially than their for-profit peers. Because of the likelihood of nonprofits being financially weak and having to merge, potentially with for-profit hospital chains,⁵ the rules governing the acquisition of a nonprofit hospital by a for-profit entity will become more important commercially. Because many of these facilities are financially distressed and buyers want to avoid successor liability if possible, many of these acquisitions may also occur in the context of a bankruptcy proceeding.



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Acquisitions of nonprofits by for-profit hospital chains has occurred with increasing frequency. For example, since the beginning of 2010, there have been these large transactions: (1) the

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sale of Forum Health, a three-hospital system based in Youngstown, Ohio, for more than \$100 million to Community Health Systems;⁶ (2) the sale of Detroit Medical Center for financial considerations of approximately \$1.5 billion to Vanguard Health System;⁷ and (3) the sale of Boston's Caritas Christi Health Care to private-equity group Cerberus Capital Management LP.⁸

Sales of Nonprofit Assets Before the 2005 Amendments

The financial and regulatory issues facing the hospital industry put the issues related to the transfer of nonprofit hos-

pitals on the "front burner" in the mid-1990s.⁹ Not surprisingly, these issues surfaced in bankruptcy cases as well.



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In 1997, a bankruptcy court in a highly publicized case dealt directly with a state regulator's power to oversee the transfer of a nonprofit hospital to a for-profit entity. In *United Healthcare Systems*, the debtor solicited

bids pre-petition, selected a winner and signed a sale agreement that contemplated a chapter 11 filing. The commissioner of Health and Senior Services for the State of New Jersey authorized the debtor's closure and authorized the purchaser to operate the hospital. Post-petition, unsuccessful bidders challenged the sale on the

Intensive Care

³ See, e.g., "The Impact of Healthcare Reform on Hospital Consolidation," *Becker's Hospital Review* (Sept. 16, 2010) ("[H]ealthcare reform will affect hospital consolidation in three ways: by decreasing revenues, increasing costs and rewarding integration"), www.beckershospitalreview.com/hospital-transactions-and-valuation-issues/the-impact-of-healthcare-reform-hospital-consolidation.html (last visited on April 27, 2011).

⁴ Of the approximately 5,795 hospitals in America in 2009, approximately 2,918 were nonprofits, or more than half. Am. Hospital Assn., "Fast Facts on U.S. Hospitals," www.aha.org/aha/resource-center/statistics-and-studies/fast-facts.html (last visited on April 27, 2011).

⁵ Anne Law, "Health Reform Sparks Hospital Merger Madness," *Bizology* (Dec. 10, 2010) ("After weathering the economic storm of 2008 and 2009, many hospitals that managed to hang on to their status as not-for-profits...continue to struggle financially, and some are determining that going it alone is not the wisest course with more uncertainties to come. Others are choosing to consolidate to meet Obama's initiatives for cost-control measures and regional cooperation among facilities."), www.bizology.com/2010/12/10/health-reform-sparks-hospital-merger-madness/ (last visited on April 27, 2011).

⁶ "CHS Outbids Ardent for Forum Health," Aug. 5, 2010, www.wyvtv.com/content/news/local/story/CHS-Outbids-Ardent-for-Forum-Health; Larry Ringler, "AG Cordray Stresses Role in Forum Sale," July 20, 2010, www.tribtoday.com/page/content/detail/id/539819.html?nav=5021 (last visited on April 27, 2011).

⁷ "A New Partnership for Detroit," Dec. 30, 2010, www.dmc.org/new-partnership/ (last visited on April 27, 2011); "Michigan Attorney General Cox Approves DMCVanguard Deal," Nov. 15, 2010, www.dmc.org/newpartnership/; Mike Cox, Attorney General of Michigan, "Report on the Proposed Sale of the Detroit Medical Center Hospital Businesses to Vanguard Health Systems Inc.," Nov. 13, 2010, www.dmc.org/newpartnership/ (last visited on April 27, 2011).

basis that the "highest and best" offer was not selected during the process. The bankruptcy court agreed, ordering the state to reverse the regulatory action in approving the transfer. The district court overruled, finding that in addition to considering the economics of the transaction, the bankruptcy court must take public health concerns into account.¹⁰

These issues arose again in 1998 when Allegheny Health Education and Research Foundation (AHERF) filed for

⁸ Suzanne Sataline, "Cerberus Takeover of Caritas Christi Gets Judge's Okay," *Wall Street Journal Health Blog* (Oct. 29, 2010), <http://blogs.wsj.com/health/2010/10/29/cerberus-takeover-of-caritas-christi/>; Lindsey Dunn, "Massachusetts Attorney General Approves Caritas Christi Sale," *Becker's Hospital Review*, www.beckershospitalreview.com/hospital-transactions-and-valuation-issues/ (last visited on April 27, 2011).

⁹ See U.S. General Accounting Office, "Not-for-Profit Hospitals Conversion Issues Prompt Increased State Oversight," GAO/HEHS-98-24 Not-for-Profit Hospital Conversions (December 1997).

¹⁰ *In re United Healthcare System Inc.*, 1997 U.S. Dist. LEXIS 5090 (March 26, 1997).

¹ The authors thank Karen Cordry, Bankruptcy Counsel at the National Association of Attorneys General, for her thoughtful and insightful comments in reviewing a draft of this article.

² Pub. L. 111-148, 124 Stat. 119-1025 (2010).

bankruptcy in Pittsburgh.¹¹ In October 1998, the Pennsylvania attorney general became concerned that a trustee was going to be appointed to sell the debtor's assets, and so sought and obtained—in the state's orphan's court—an *ex parte* order enjoining the debtor from taking certain actions with regard to its directors and assets. In response, the bankruptcy court issued an injunction, finding that it had sole jurisdiction over these issues and enjoining the attorney general from taking further actions in connection with the orphan's court proceedings, and declaring the orphan's court *ex parte* order “null and void.” On appeal, the district court found that the attorney general's actions were exempt from the automatic stay as a “police or regulatory power” and stayed the bankruptcy court's orders pending appeal.¹²

Given the nationwide attention being drawn during this period to the transfers of nonprofit assets to for-profit entities, attorneys general encouraged Congress to amend the Bankruptcy Code to preserve what they saw as their rightful position over the disposition of charitable assets. Congressman George Gekas (R-Pa.) sponsored H.R. 3150, the Consumer Bankruptcy Reform Act of 1998, which included language that ensured that charitable entities could not use bankruptcy as a means of evading the states' long-standing role in controlling the disposition of charitable assets. In evaluating the inevitable conflict between the bankruptcy policy of maximizing return for creditors and the desire of regulators to ensure that charitable assets are used to maximize the benefit to the community, Congress opted to come down on the regulators' side.

These proposals were included in the 1998 House-Senate Conference Report version of H.R. 3150.¹³ The report was approved in the House on Oct. 9, 1998, by a vote of 300-125, but due to the lateness of the session in an election year and cloture issues, it did not come to a vote in the Senate. For the next six years, the proposals regarding amending the Bankruptcy Code *vis-a-vis* nonprofit asset sales sat without action on Capitol Hill until they were included in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which passed in April 2005.¹⁴

Post-BAPCPA Transfers of Nonprofit Assets

BAPCPA made three significant amendments to the Code relating to the transfer of nonprofit assets, in §§ 363(d), 541(f) and 1129(a)(16). Section 363(d) now provides that the trustee may only sell or lease property under subsections (b) and (c) in accordance with applicable nonbankruptcy law that governs the transfer of property by a nonprofit entity. Section 1129(a)(16) was added to provide that in confirming a plan, the court must similarly find that all transfers of property under the plan are made in accordance with applicable nonbankruptcy law that governs the transfer of property by a nonprofit entity. Section 541(f) was added to provide that a debtor's property that is a tax-exempt, nonprofit charitable corporation under § 501(c)(3) of the Internal Revenue Code may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the debtor had not filed a bankruptcy case.

There are also two BAPCPA provisions that may affect such transactions that were not codified. Section 1221(d) of BAPCPA expressly states that “the court shall not confirm a [chapter 11] plan...without considering whether this section would substantially affect the rights of a party in interest... The parties who may appear and be heard in a proceeding under this section include the attorney general of the State in which the debtor is incorporated, was formed, or does business.” Additionally, § 1221(e) expressly states that “[n]othing in this section shall be construed to require the court in which a [chapter 11] case...is pending to remand or refer any proceeding, issue or controversy to any other court or to require the approval of any other court for the transfer of property.”

Outside of bankruptcy, states have many laws restricting the transfer of nonprofit hospitals. For example, many states have enacted “conversion” laws that regulate the conversion of nonprofit hospitals to for-profit hospitals.¹⁵ Many other states allow an attorney general to use common law or general laws governing trusts or nonprofits to provide oversight over the conversion of nonprofit assets even in the absence of express statutory authorization. The attorney

general of a state typically oversees the operation and disbursement of charitable assets, including the sale of a nonprofit hospital, under the *parens patriae* or *cy pres* doctrines. This review is required because “not-for-profits, unlike their for-profit counterparts...do not have shareholders to whom profits are distributed. Given the absence of shareholders, profits and other market devices to ensure the efficacy of contracts and regularity of operations...[applicable nonbankruptcy law] contemplates significant public oversight of the finances and major transactions” of nonprofit entities.¹⁶ While in many states, including California, the attorney general carries out this role; in other states, such as New York, some nonprofit corporations must obtain leave of the New York Supreme Court before disposing of all or substantially all of their assets.

The applicable guidelines for review by a state's attorney general differ from state to state, but those in § 5917 of the California Corporations Code are typical. This statute states that the attorney general may consider any factors deemed relevant, but expressly mentions the following factors: (1) whether the terms and conditions of the proposed transaction are fair and reasonable to the nonprofit corporation; (2) whether the proposed transaction will result in inurement to any private person or entity; (3) whether the proposed transaction provides a fair-market value to the nonprofit; (4) whether the market value has been manipulated by the parties' actions in a manner that causes the value to decrease; (5) whether the proposed use of the assets from the proposed transaction is consistent with the “charitable trust” or mission of the nonprofit entity; (6) whether the proposed transaction constitutes a breach of trust; (7) how the proposed transaction affects the public; (8) whether the proposed transaction creates a significant effect on the availability or accessibility of health care services to the public; and (9) whether the proposed transaction is in the public interest.

The pending case of *Victor Valley Community Hospital (VVCH)* presents a good example of how this approval process works after BAPCPA. VVCH, located in Victorville, Calif., filed its chapter 11 petition on Sept. 13, 2010, and obtained court approval to hold an auction of substantially all its assets with a nonprofit stalking-horse bidder on Nov.

¹¹ Case Nos. 98-25773 through 98-25777 (Bankr. W.D. Pa.).

¹² *In re Bankruptcy Appeal of Allegheny Health, Education and Research Foundation*, Appeal of Order Staying/Enjoining Orphans Court Proceedings, 252 B.R. 309 (W.D. Pa. 1999).

¹³ See H.R. 105-794, Cong. Rec. H9954-9985 (Section 733).

¹⁴ Pub. L. No. 109-8.

¹⁵ Jill R. Horowitz, “State Oversight of Hospital Conversions: Preserving Trust or Protecting Health?,” The Hauser Center for Nonprofit Organizations, The Kennedy School of Government Harvard University (September 2002), available at Social Science Research Network Electronic Paper Collection, http://ssrn.com/abstract_id=XXXXXX (discussing in detail hospital conversions from nonprofit to for-profit entities).

¹⁶ 64th Assocs. LLC v. Manhattan Eye, Ear & Throat Hospital, 2 N.Y. 3d 585, 813 N.E.2d 887 (2004).

5, 2010. Under applicable nonbankruptcy law, the debtor was required to notify the attorney general of the proposed sale and submit a lengthy application seeking the attorney general's approval of the transfer. Although the attorney general usually will not allow submissions until they are complete, given the debtor's time constraints the attorney general agreed to allow the debtor to submit the application in parts: The parts that dealt with the debtor could be completed before the auction; the remainder, dealing with the transaction and the buyer, would be submitted promptly after the auction. At the auction, the stalking-horse bidder was overbid by a for-profit entity. After the auction's results were approved by the debtor's board of directors (which included consideration of non-monetary aspects of the bids) and by the bankruptcy court, the remainder of the application was submitted to the attorney general.

As part of its review of the transaction, the attorney general retained the services of a health care consulting firm (at the debtor's expense) to do a review of the buyer and the proposed transaction and provide a written recommendation to the attorney general. Additionally, the attorney general solicited written comments from the public and held a public hearing on the proposed sale. The attorney general's office had agreed to expedite the review of the application, which normally takes several months, and produced a "conditional approval" on Dec. 29, 2010. Unfortunately, the attorney general's conditional approval imposed several conditions on the buyer that significantly increased the economic cost of the transaction to the buyer. At press time, the resolution of how the debtor and the buyer will deal with those conditions is still unresolved.

Conclusion

BAPCPA's amendments brought about a significant legislative imposition on a nonprofit entity seeking to sell its assets through bankruptcy to a for-profit entity. However, the changes in many ways were consistent with the rulings of courts nationwide at the time the changes were first proposed. While a debtor's arguments may be more limited than they were before 2005, in practice courts had already been respectful of the power of regulators to oversee the disposition of nonprofit assets. While the obligations are not insignificant and add some delay and expense to the transaction, they are also not insurmountable. All in

all, the utility of selling a nonprofit hospital's assets through bankruptcy is not destroyed by BAPCPA. ■

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