

# HOSPITAL BANKRUPTCY:

What board members, executives, and other  
stakeholders need to know

As health care reform moves forward, industry analysts foresee declines in hospital operating margins. Many hospitals are facing a credit rating downgrade at a time when credit remains hard to obtain, and must consider options for financial restructuring to avoid a bond covenant default and tumbling into bankruptcy.

Hospital leaders contemplating Chapter 11 protection will face obstacles which may diminish, rather than increase, the hospital's chance of survival. Before seeking Chapter 11 protection, a hospital should weigh all available options of this business strategy.

It's imperative that board members recognize the early stages of financial distress so solutions can be found to avert bankruptcy protection. With early and swift intervention, the hospital can continue to serve the community and reduce the risk for financial stakeholders. At the earliest signs of financial distress, the leadership should retain professionals with a proven record in hospital turnarounds. These experts can help determine whether a turnaround is possible – or whether it's necessary to seek bankruptcy restructuring.

QHR Intensive Resources (QIR) has extensive experience in both hospital turnarounds and the bankruptcy restructuring process. We provide short-term, high-intensity services that help restore hospitals to financial health as quickly as possible.

In bankruptcy, creditors have defined roles and representation. Members of the community, who are the “stakeholders” of a non-profit hospital, typically have no mechanism for representation.

A financial restructuring or workout accomplished consensually outside of bankruptcy court generally is less expensive and less time-consuming than a restructuring under Chapter 11 of the Bankruptcy Code (Chapter 9 for publicly-owned hospitals). Chapter 11 can be a costly process in terms of both monetary and non-monetary resources.

For a workout plan to be successful, a hospital must have some cash for settlements with minor payables and

generate enough cash flow to honor payment plans with major vendors.

A workout typically involves negotiations to restructure bond debt, other secured debt, and unsecured cash needs, and may involve efforts to obtain refinancing (or additional financing) and alternate credit terms with all creditors.

However, an out-of-court workout lacks some of the advantages of a bankruptcy proceeding under bankruptcy protection. The “automatic stay” can provide significant relief to a hospital that is experiencing difficulty managing its creditors. In addition, suppliers will normally not refuse fulfilling the terms of existing contracts because of pre-petition claims – vendors know they will be paid in full for services rendered while the hospital is in Chapter 11. Once a decision is made to file a bankruptcy petition, the hospital will need assistance cataloging and managing claims, giving notices to creditors, and filing the required bankruptcy schedules.

QIR offers a broad range of support for hospitals considering restructuring options. We also help hospitals considering a bankruptcy filing to carefully choose the attorneys, accountants, and public relations consultants who will be retained.

Between 2000 and 2006, 42 U.S. acute care hospitals filed for bankruptcy protection under federal law. 67 percent of hospitals filing for bankruptcy during this time eventually ceased operating. Of the hospitals that filed, 14 (33 percent) either emerged from bankruptcy or remain open either in or out of bankruptcy reorganization as of October 2008.

## SIGNS OF DISTRESS

### Operational Indicators:

- ◆ Hospital staffing levels are too high compared to their patient volume, or the hospital may be using expensive temporary or agency personnel. Failing to meet regulatory requirements in this area is an alarming sign.

- ◆ Declining outpatient volumes, which weigh heavily on operating margins.
- ◆ Declining physician relations: physicians move out, particularly in highly competitive markets.
- ◆ Declining employee relations: low morale and turnover are bad signs.
- ◆ Quality and accreditation issues: The bottom line can take a hit from fines related to insufficient regulatory compliance, including related litigation expenses and damage to reputation.
- ◆ Commitments with vendors to pay off the hospital's debts are not honored.
- ◆ Receiving letters from one or more vendors asserting their filing or expected filing in federal court to seek payment for services rendered to the hospital.
- ◆ The Board "senses" a problem with the hospital's financial state of affairs and its confidence in senior management is on the decline. Senior management's answers and actions are not sufficient, resulting in tense board and finance committee meetings.
- ◆ Not adapting quickly to health reform.

### Financial Indicators:

- ◆ Decreasing cash on hand: cash on hand below 60 days.
- ◆ Assets/Liabilities ratio: 1.5 indicates possible early distress; 1.0 requires immediate attention.
- ◆ Accounts receivable problems: increasing bad debt and increases in uncompensated (charitable) care, due in part to an increased number of unemployed, uninsured patients; AR aging categories worsening may portend decreased liquidity.
- ◆ Capital expenditures vs. annual depreciation: recently, over half of all hospitals have delayed a scheduled capital project or halted an active project (AHA). If depreciation has outpaced capital improvements in more than 3 of the last 10 years, the hospital may be distressed (especially when unable to access new financing in today's credit markets).
- ◆ Internally prepared financial statements lack key data or fail to predict performance.
- ◆ Lacking a cash management methodology: cash is declining with payables increasing.

### Market Indicators:

- ◆ Area unemployment of 10% or higher, resulting in widespread loss of employer-provided insurance. Hospitals in communities feeling the brunt of the recession may experience significant decreases in patient volume and/or increases in charity care and bad debt.
- ◆ Hospitals in communities with declining populations are at risk.
- ◆ Communities experiencing the loss of a major industry place the hospital at risk for significant financial distress.
- ◆ Declining investment portfolios.
- ◆ Declining charitable giving to the hospital.

### QHR Intensive Resources as an Advisor

We specialize only in health care. Our relationships include not-for-profit hospitals (CAH and PPS), private hospitals, and investor-owned hospitals. QIR professionals also have experience in other facets of health care, including nursing homes, assisted living, managed care, ambulatory care centers, and multi-specialty physician group practices.

We assist hospitals in identifying and implementing strategies to reduce costs, increase revenue, maximize asset values, obtain financing, and identify potential strategic partners or purchasers. We also assist in interacting with governmental entities, creditors, doctors, employees, and the general public. Our professionals lend much-needed credibility to the hospital in its negotiations and dealings with creditors, regulatory authorities, unions, and other constituencies in both out-of-court workouts and bankruptcy cases.

### Why act early?

- ◆ There is little time for "on the job training" in a hospital insolvency context. The dominoes start to fall quickly.
- ◆ Less than one third of hospitals survive bankruptcy.
- ◆ A financial restructuring or workout accomplished consensually outside of bankruptcy court generally is less expensive and less time-consuming than a restructuring under Chapter 11 of the Bankruptcy Code.

Chapter 11 can be a costly process in terms of both monetary and non-monetary resources.

In 2009, Bankruptcy Creditors' Service, Inc. recorded seven hospital bankruptcy filings. Troubled Company Reporter, a daily newsletter that tracks large companies and their credit quality, reported that nine hospitals have filed for bankruptcy through October 2010.

## DIFFERENCES BETWEEN CHAPTER 11 AND CHAPTER 7 BANKRUPTCY

In a Chapter 7 liquidation, hospital management is immediately replaced by a bankruptcy trustee authorized to operate the hospital for a short period of time. Local management loses "possession" of the hospital's assets because once a Chapter 7 petition is filed, the bankruptcy trustee is the only authority entitled to act on the hospital's behalf.

Most hospital bankruptcies are filed under Chapter 11 of the Bankruptcy Code because it enables current management to continue operating the facility while developing a plan to maintain operations and restructure debts. A Chapter 11 case may result in a reorganization through which the hospital emerges as an operating entity with a restructured balance sheet. Or it may end in either an orderly wind-down and/or a sale or merger with another entity.

## BANKRUPTCY CHALLENGES AND STRATEGIES

Each hospital bankruptcy is unique. There are many variables in a bankruptcy: long-term debt, short-term debt, and actual performance. Hospital leadership must exhibit strategic readiness in these areas:

## Leadership

The hospital's governing board should be prepared to take prompt action if a hospital's performance slips. This involves creating a strategic plan and communicating effectively with community leaders. The executive team, along with the board, must openly address the simultaneous demands of creditors, courts, regulatory agencies, suppliers, employees, the press, community leaders, and the general public.

Bankruptcy proceedings involve considerable time and resources, and may distract from operational and restructuring initiatives. There's a lot to balance, and a firm like QIR can help hospital leaders achieve multiple objectives during this period.

Successful boards set the tone for the entire institution – and are the embodiment of its commitment to quality, community service, and effective financial stewardship. [from QHR White Paper "Managing A Hospital Turnaround."]

## Business and Financial

A hospital's business operations must continue to serve the needs of the community before, during and after the bankruptcy. Many hospitals have other assets and run other services, such as satellite clinics, a nursing home, a certified home health agency, senior housing, medical education/training programs, and ambulance services.

The hospital will face immediate choices: reduce or eliminate certain services, consolidate or share services with other area hospitals, or possibly merge with another hospital or system. Often, the hospital must sell off some of its operations or real estate in order to survive and emerge from bankruptcy. It is critical to conduct a top-to-bottom review of revenues and collection practices to determine the profitability and value of services lines – and to ensure that the hospital is getting paid all that it's entitled from Medicare, Medicaid, private insurers, managed care plans, and other payers on a timely basis. Other areas that must be addressed include:

- ◆ Retaining employees (especially physicians), the lifeblood of the business
- ◆ Obtaining alternative financing/restructuring financing, including Debtor-In-Possession (DIP) financing
- ◆ Restructuring bond debt and other secured debt
- ◆ Obtaining refinancing
- ◆ Obtaining alternate credit terms with vendors
- ◆ Paying employee wages
- ◆ Paying critical vendors
- ◆ Paying for insurance

## Regulatory

Although governmental entities are prohibited from revoking licenses, permits and charters solely because a debtor files for bankruptcy, a bankruptcy filing will trigger increased scrutiny by regulators. In contemplating a bankruptcy filing, a hospital must determine which licenses to retain after the bankruptcy – and whether specific action is needed to preserve those licenses. Other issues include:

- ◆ CHAPA and Attorney General/court approval
- ◆ Employee status, including pension obligations and notification of layoffs or closing
- ◆ WARN Act stipulates that layoffs or plant closings involving >100 employees be disclosed 60 days in advance
- ◆ Patient Medical Records management
- ◆ Certificate of Need (CON) filing

## Community

Community fallout from a hospital bankruptcy can be severe, and tends to hit all at once. Hospital leadership must actively address:

- ◆ Loss of community support
- ◆ Perceived decline in quality that causes patients to use other hospitals, precipitating further decline in revenues
- ◆ Competing facilities' attempt to undermine the hospital

## Public Relations

The hospital must open and maintain a dialogue with all stakeholders, not just creditors and regulatory agencies. It is critical that a hospital develop a comprehensive public relations strategy to keep all stakeholders informed, including vendors, employees, patients, community leaders, and the general public.

Just the possibility of bankruptcy can create great anxiety within the community and the hospital, causing doctors, nurses, employees and patients to flee to other organizations. The public relations effort should therefore focus on the hospital's plan for improving its financial footing. An effective PR plan will:

- ◆ Inform the community about the realities of the situation without creating anxiety
- ◆ Open clear lines of communication to employees. Timely, honest communication can greatly aid in staff retention.
- ◆ Assure patients (and the community at large) that quality of care will remain the priority.
- ◆ Maintain positive relationships with vendors to ensure quality service without interruption.

## Legal

Legal expertise will be required in a wide array of fields, and hiring the right lawyers for each endeavor can significantly influence the course of recovery. While there are many capable bankruptcy lawyers, only a few firms have experience in navigating debtors and creditors through the complexities of health care bankruptcies. We have professional relationships with a number of these firms. While QIR brings operational expertise to restructuring scenarios, these highly experienced legal firms understand the nuances of health care law. They offer guidance in:

- ◆ Bankruptcy law
- ◆ Corporate law in the realms of financing and restructuring
- ◆ Real estate

- ◆ Labor law
- ◆ Tax law
- ◆ Unions

## Union Strategy

Union contracts may have to be renegotiated, or in extreme cases may even be voided by the Bankruptcy Court. If the hospital has a qualified pension plan, it will likely have to deal with the Pension Benefit Guaranty Corp., which protects employees' interests in retirement benefits.

## Exit Strategy

It's impossible to overstate the importance of planning for a hospital's emergence from bankruptcy. For every month in bankruptcy, the hospital incurs professional fees and will be required to devote extraordinary internal resources to the reorganization effort. Thus, the success of reorganization depends upon minimizing those costs by shortening the time spent in bankruptcy. Developing an exit strategy before filing bankruptcy will aid in reducing the costs and disruption of a filing. Hospital leadership must have a clear vision of whether the exit strategy involves a sale, merger or stand-alone reorganization.

## COMPETING INTERESTS: BOARD VS. BOND HOLDERS VS. COMMUNITY

The board must balance the competing interests of the bond holders (who are eager to recoup their investment) and the community, for whom an outright closure of the hospital would be an unmitigated disaster. The bond holders may or may not be made whole through a sale or a closure/liquidation of assets, but the best interests of the employees and the community as a whole are to keep the hospital operational. This can create tension, but ultimately both groups (hospital and bond holders) will benefit from a return to financial solvency.

### Bond Holders

Hospital leaders must be prepared in the event that secured creditors push for an asset sale to recoup a

portion of their investment. If that effort fails, creditors may then call for conversion of the case to Chapter 7 liquidation.

## The Community Interest

The hospital serves vital community needs: employment, business for local vendors, and a source of quality health care services. A decline in quality will negatively impact patients, physicians, and all employees. If the hospital closes, it's a blight on the whole community, bringing job losses and limiting the ability to attract new business to the area. A closed hospital is worse than worthless because it carries ongoing costs to local government, such as maintaining security of the property and lower property values in the community.

## BANKRUPTCY SALE CONSIDERATIONS

In some cases, hospital bankruptcies are filed for the purpose of achieving a sale, or will involve a sale if it becomes apparent that the hospital cannot survive as an independent reorganized entity. QIR can assist the hospital in all aspects of this complex process, from pre-sale activities through the sale and hand-off of hospital operations.

### QHR Intensive Resources' Chapter 11 Restructuring Support

Every bankruptcy is a unique process, requiring a customized approach to achieve a successful outcome. We offer extensive support both before and during a Chapter 11 filing. The capabilities listed below are applied as needed throughout each phase of QIR's engagement:

- ◆ Oversight and control by senior-level executives with expertise in health care operations, restructuring engagements, and exit strategies.
- ◆ Consulting services most applicable to ongoing operational support include:
  - Clinical Integration
  - Clinical Operations
  - Compliance
  - Managed Care Services

- Public Relations
- Regulatory/Accreditation Readiness
- Reimbursement
- Revenue Cycle Services
- Service Line Planning
- Supply Chain

◆ Additional consulting services available as needed:

- Case Management/Clinical Documentation Management
- Facility Development
- Health Information Management
- Human Resources
- Information Technology
- Patient Financial Services
- Patient Throughput (ED/OR)
- RAC Services

In addition to this broad range of services, QIR experts also help the hospital successfully navigate bankruptcy through four simultaneous processes:

### Management of Hospital Operations

- ◆ Finding interim CEO/CFO for ongoing management of the hospital
- ◆ Continued consulting support for contracted services such as Revenue Cycle and ChargeMaster
- ◆ Service line development, such as:
  - Emergency Room      • Primary Care
  - Cardiology              • Physical/Occupational Therapy
  - Orthopedics            • Swing Beds
- ◆ Compliance support

### Special Relationships with the Bond Trustee and Agents

- ◆ Manage draws on Debtor in Possession financing
- ◆ Provide weekly financial information and cash forecasts
- ◆ Broker sale if applicable
- ◆ Report on progress of implementing improvements

### Support Through the Sales Process

- ◆ Quantify operational improvements
- ◆ Complete initial draft and finalize informational sales packet
- ◆ Develop and maintain the “data room” available to potential suitors (repository of comprehensive hospital data – organizational, statistical, financial, contractual, etc.)
- ◆ Respond to special requests by potential suitors
- ◆ Host potential suitors on-site
- ◆ Assist with gathering and providing documents to initial due diligence requests and due diligence for the final suitor (if sale is approved by the board and bondholders)

### Support Counsel During Chapter 11

- ◆ Address compliance issues as directed by hospital’s counsel as part of the exit strategy
- ◆ Respond to requests from the bankruptcy court or hospital’s bankruptcy counsel
- ◆ Participate in meetings and conference calls with creditors’ legal counsel
- ◆ Host and provide information to the ombudsman
- ◆ Complete 13-week cash forecasts
- ◆ Resolve ongoing issues that impact the parties of interest (bondholders and their representatives, potential suitors, etc.)

**END RESULT: Assist in the Execution of an Acceptable Bankruptcy Strategy for Board Approval**

### SUMMARY

At the earliest signs of financial distress, a hospital should retain an experienced team like QHR Intensive Resources (QIR). Early intervention can often help a hospital avert bankruptcy altogether, allowing the facility to continue serving the community and reducing the risk for financial stakeholders.

If bankruptcy restructuring is the only viable option, QIR can provide wide-ranging assistance throughout the restructuring process (as detailed in this paper).

QIR is a wholly owned subsidiary of Quorum Health Resources (QHR), the market leader in hospital management, serving about 150 multi-year clients across the U.S. QHR is the seventh largest healthcare management consulting firm in the U.S. and a leader in continuing education. The QHR Learning Institute reaches more than 10,000 healthcare professionals each year.

If you would like to discuss this or other topics or want to learn more about QHR, contact:



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## OTHER RESOURCES

1. QIR White Paper: "Managing a Hospital Turnaround: A Board Primer"
2. QIR White Paper: "Lessons from Successful Critical Access Hospital Turnarounds"
3. QIR White Paper: "Early Warning Signs of a Distressed Hospital"