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Healthcare Loans: Five Tips for a Potentially Successful Workout

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September 2017

By now, most people that follow financial news are aware that the amount of troubled healthcare related companies are on the rise, which by its very nature, causes more distressed healthcare related debt in the market. Although much of the reporting has focused on hospital systems, including community based and rural hospitals, filing for bankruptcy, other healthcare related entities are finding themselves in distress and may potentially be crossing the threshold of a bankruptcy court.

Run a simple Google search under "distressed healthcare companies," and you will find a wide range of analysis as to what may be causing financial distress in the healthcare market: (1) uncertainty with the fate of the Affordable Care Act ("ACA");[1] (2) reduction in reimbursement rates from both insurance companies and the federal government; (3) lack of Medicaid expansion in certain states; (4) the rising cost of providing care; and (5) the increased complexity in the regulatory landscape, just to name a few.

At the time of rising distressed healthcare debt, it also appears that more lenders, both traditional and non-traditional, are entering the healthcare market in hopes of opening up new avenues of profitability. With new lenders entering the market, there will be new loans made, but this also raises the likelihood that if some of these loans go bad, lenders may have to handle a distressed healthcare credit.

As lawyers, we are seeing an increase in healthcare related debt restructurings (*i.e.*, "workouts"). As with any niche and highly-regulated industry, there are nuances to the field that a lender needs to be aware of in order to successfully exit the credit, payoff the loan, and/or minimize a potential write-off. As with many things in life, reacting early and planning in advance sets up a higher likelihood of success and obtaining goals. Healthcare workouts are no different.

Due to the complexity of any potential workout, more than a simple e-alert would need to be dedicated to discuss the potential issues that may arise; however, below are five observations and tips for reacting and setting up a potential successful healthcare related workout.

1) **Start Early and Get Your Own Information**. At the first sign of distress, whether that is a covenant default or some other financial trigger indicating trouble, think about exercising any

[1] At the time of writing this e-alert, the ACA was still currently intact in its original form; however, the Graham-Cassidy amendment (S.Amdt. 1030) to the American Health Care Act of 2017 (H.R. 1628), was still pending in the United States Senate. Although the merits of American Health Care Act of 2017 and the Graham-Cassidy Amendment are not relevant to this Article, it can be assumed that if the bill passes and becomes law, further disruption will occur within the healthcare market.

rights you may have to conduct a field audit. Although you may trust the borrower's CFO, she/he may be unaware of an issue festering within the company. An objective third party could notice the issue and raise it to a level of concern potentially minimizing the issue's impact on the borrower.

Some lenders have specialized teams that are trained to review and analyze niche borrowers such as those in the healthcare field. If your company does not have such a specialty group, a financial advisor should be hired, particularly one having extensive healthcare experience. Sending in a generalist financial advisor may save some money on the front end, but there are nuances to a healthcare company's revenue cycle, financials, and other practices that need to be analyzed by a professional with healthcare experience. Bottom line, if you are going to advise your financial institution or company with respect to the loan, you need your own reliable information.

2) **Careful How You Tread**. Although this may seem to contradict the advice above, unless you have minimal trust in your borrower or its first sign of distress demonstrates the need for a more aggressive approach to the field audit, try to work with your borrower to minimize disruption to the company because any commotion to the normal business practice may further exacerbate the distress. Put another way: try not to scare the revenue generators of the company.

For example, with the increase desire for consolidation in the healthcare field, many medical practices are rolled under the umbrella of a single parent company, with the business side of the practice being run at a headquarters far away from the actual onsite medical practice. The revenue of the borrower may be generated by doctors working in these practices separate and apart from the company's headquarters. Sending in what could amount to a SWAT team of accountants may signal trouble to the revenue generators (*i.e.*, the doctors), thereby causing them to reconsider the prospects of working for the borrower. If doctors start to leave, revenue may decline causing greater distress.

The above-described situation is a tough spot for any lender because it requires a balancing of the need-to-know information, on one hand, with the concern over potentially increasing the financial distress on the other. These types of situations can be resolved, but they require a delicate balance of knowing when to trust information from your borrower and understanding what information needs to be obtained directly from the source. Some situations may call for a robust field audit, reviewing firsthand all of the borrower's books and records; other situations may only require a less comprehensive approach. When in doubt on how to proceed, rely upon your professionals in coming up with an appropriate strategy to balance the need-to-know information with the concern of causing more distress.

3) **Conduct and/or Re-conduct the Due–Diligence**. Do not just rely on the due diligence that was conducted when the loan was originated. Moreover, although typical loan documents may require it, do not rely on your borrower to tell you when a covenant/representation has been breached or an event of default has occurred. Assume that these instances will go unreported.

With that being said, there is no area of more particular concern than ensuring that your borrower retains whatever license(s) it needs to sustain its operations. As with many healthcare companies,

even figuring out what license — or licenses as is usually the case — your borrower is required to have may be difficult. Many states have subset after subset of specialty licenses. Many healthcare companies operate out of multiple states, further compounding the complexity of confirming what license(s) are required. When in doubt, your professional advisors should be consulted in order to determine the required license(s) your borrower needs in order to be compliant with the pertinent licensing authority.

Once confirmed, obtain proof of the issued license(s) and confirm with the specific licensing authority that the license is in good standing. Without the properly issued license(s), successfully working out a troubled healthcare credit will be difficult at best, if not doomed from its inception.

4) **Reconfirm Your Borrower's Payer Mix**. Your borrower's payer mix may have shifted from when the loan was originated. When conducting due diligence, it is important to obtain updated information regarding the source of your borrower's revenue. Pay particular attention if out-of-network payments to your borrower have increased. Although out-of-network payments can mean that your borrower is receiving higher reimbursement rates, it is not uncommon for insurance companies to dispute invoices and delay payment to out-of-network providers. Moreover, some insurance companies may employ the practice of sending reimbursements to the patient directly, instead of the provider (*i.e.*, your borrower).

Some insurance companies may employ this practice in hopes of incentivizing a routine out-of-network provider to go in network. In theory, the patient is then supposed to remit the funds to provider; however, as you can imagine, those funds may not always make it to your borrower.

With so many healthcare credits lacking in hard collateral (*see* below), the A/R may be the most valuable asset. At best, it should be assumed that collecting the A/R from the patient may delay the revenue cycle. Moreover, collecting the receivables may also prove costly because attorneys and/or collection companies may need to be retained. If your borrower's A/R aging report demonstrates heavy amounts owed by individuals, it may be necessary to discount the value of those receivables because they may be deemed uncollectable.

5) **Watch the Value of Your Collateral**. Your borrower may be valuing its equipment and inventory on its financials at one dollar amount; however, in reality its value on the open market may be deeply discounted. In our experience, the resale value on durable medical goods is not great and the liquidation price that it might obtain could be far less than anticipated by the lender. Also keep in mind that some of your borrower's valuable equipment may be subject lease or a *quasi* financing arrangement, meaning that some other creditor may have priority to it.

Also bear in mind that some of your borrower's inventory may not be easily re-sold or liquidated. In some situations we have experienced, to even possess the inventory the owner has to be licensed or credentialed (*e.g.*, some sort of controlled substance). Meaning if the collateral has to be repossessed, you may have to hire a third party that is licensed to hold the collateral before it can be resold. In this type of situation, the inventory may only be transferrable to a small subset of

buyers, placing limits on the potential purchasers and potentially diminishing its value because of the lack of a market for the product.

Final Thoughts

The above tips and observations are not comprehensive and only represent a small subset of the potential situations a lender might have to navigate in a potential out-of-court workout with a healthcare credit. Hopefully, they trigger other thoughts and strategies that may prove useful for present and future matters. When in doubt, seek out professional advisors to help you navigate the potential issues that arise with a troubled healthcare company.

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