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Intensive Care

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When Cash Might Not Be King

Acquiring Nonprofit Hospitals in Bankruptcy

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Transactions involving financially distressed hospitals often implicate a wide array of complicated issues. Hospitals are highly regulated, and their business models are unique. In addition, hospitals are often owned and operated by nonprofit entities with charitable missions that differ substantially from the value-maximization principles that guide the fiduciaries of a for-profit company. A nonprofit entity's charitable mission can become particularly important in the context of a sale of a hospital pursuant to § 363 of the Bankruptcy Code.

In recent years, the chapter 11 process has morphed into a vehicle for facilitating change-of-control transactions. Sales of substantially all of a debtor's assets are common, and most sales of a debtor's business are accomplished pursuant to 11 U.S.C. § 363. In a typical § 363 sale, "cash is king," and it is unusual for a debtor/seller to receive other forms of consideration (*e.g.*, debt or equity issued by the purchaser). Although in most cases the bidder offering the most cash will prevail, when the debtor is a nonprofit entity, the traditional calculus of "highest bid wins" might not apply. Some courts have even held that the nonprofit's charitable mission must be considered when evaluating competing transaction proposals.

Case Law in Hospital Sale Cases

An early case addressing this issue is *In re United Healthcare System Inc.*, where the U.S. District Court for the District of New Jersey reversed a bankruptcy court's decision to deny the approval of a sale proposed by the debtor.[1] Prior to the bankruptcy filing, the debtor conducted a sale process that resulted in multiple bids for its assets. The debtor's board of trustees selected a proposal from St. Barnabas Corp. because St. Barnabas was the only bidder committed to keeping the debtor's children's hospital open.[2] When the debtor filed for bankruptcy and sought the bankruptcy court's approval of the sale, the bankruptcy court denied the motion, finding that the board's decision to award the sale to St. Barnabas was not a sound exercise of business judgment.[3] On appeal, the district court reversed, noting that a bankruptcy court must not "mechanically apply" the bankruptcy principles of "highest and best" offer to a nonprofit debtor; the court must look at the totality of the circumstances.[4] The district court concluded that the bankruptcy court "failed to acknowledge that the Board of [the debtor], a non-profit organization, had a fiduciary obligation to maintain the legacy of the [hospital]."[5] In light of the debtor's charitable mission, the district court found that the sale to St. Barnabas (even though it was not paying the highest price) was an acceptable decision by the board.

More recently, the U.S. Bankruptcy Court for the Southern District of New York considered a similar issue in *Hebrew Hospital Senior Housing*.[6] In that case, the debtor conducted a sale process that resulted in two potential buyers: Bethel Methodist Home Inc. and GF Westchester Holdings, LLC, an institutional joint venture between affiliates of Garrison Investment Group LP and Focus Healthcare Partners LLC (collectively, "Focus"). The debtor (and its board) favored a transaction with Bethel because, among other things, Bethel would continue to operate the facility as a continued care retirement community. The official committee of unsecured creditors supported the Focus bid, which offered a cash purchase price that was approximately $1 million higher than the Bethel bid.[7]

1 Case No. 97-1159, 1997 U.S. Dist. LEXIS 5090 (D.N.J. March 26, 1997).

2 *Id.* at *19.
3 *Id.* at *9.
4 *Id.* at *17.
5 *Id.* at *20.
6 *In re HHH Choices Health Plan LLC*, 554 B.R. 697, 702 (Bankr. S.D.N.Y. 2016).
7 *Id.* at *699.

The court first noted that under New York's Not-For-Profit Corporation statute, a sale should only be approved if the terms are fair and reasonable and the purposes of the nonprofit corporation are promoted.[8] "It is clear under state law," the court noted, "that price alone is not determinative, and that fulfilling a corporate mission can be decisive if creditors are all being paid in full."[9] But the issue is less clear when the nonprofit corporation is insolvent and creditors will not be paid in full.

The court discussed two possible (conflicting) approaches in the insolvency context. One view is that beneficiaries of "the charitable mission of the company essentially occupy the position that shareholders would otherwise occupy, and that their interests should take a back seat to creditor interests."[10] Under this analysis, the charitable mission would have absolutely no bearing on the selection of the prevailing bidder. The court rejected this approach because the applicable provisions of New York state law were clearly intended to apply in the case of an insolvent nonprofit corporation.[11]

The opposing view discussed by the court was one espoused in a letter from the New York attorney general to the court in support of the Bethel bid. This view provides "that the mission of the [nonprofit] has to be satisfied, and that nothing can be done unless that condition is fulfilled."[12] The court likewise rejected this approach as too narrow an interpretation of the New York statute. After reviewing the prior case law (including the *United Healthcare* decision), the court concluded that all relevant factors (including the economic terms and furthering the debtor's charitable purpose) should be evaluated and balanced with no other requirement or particular weighting to the various factors.[13]

With this standard in hand, the court proceeded to evaluate several factors related to the bids, including the financial ability of each bidder to close the transaction, the ongoing feasibility of each bidder continuing the business, the likelihood of each bidder receiving necessary regulatory approvals and the effect of the sale on various creditor constituencies (including employees and residents). In addition to these (and consistent with the analysis previously set forth), the court considered whether each bidder could fulfill the debtor's original charitable mission. While both bidders would support certain aspects of the debtor's original charitable purpose, the court found that the Bethel proposal was "more fully aligned with [the debtors'] mission" because Bethel proposed to continue using the facility as a continued care retirement community for approximately 85 senior citizen residents.[14]

After weighing all of the factors, the court sided with the debtor and its board and approved the Bethel bid over the Focus bid, notwithstanding the fact that the financial considerations weighed "slightly in favor" of Focus.[15] In reaching its decision, the court also addressed whether deference should be afforded to the debtor's board of directors (which had selected the Bethel proposal). The court declined to defer to the board because, among other reasons, the evidence suggested that the board was not fully informed and failed to appropriately weigh the competing interests in making its decision (including by failing to give due consideration to the Focus transaction proposal).[16] This aspect of the court's decision highlights the need for boards to stay appropriately informed, consider all relevant information that is reasonably available and engage in reasonable deliberations when evaluating competing transaction proposals.

Implications for Buyers of Distressed Hospitals

In light of the *United Healthcare* and *Hebrew Hospital* opinions, buyers of distressed nonprofit hospitals should be cognizant of the non-economic features of their bids and whether those terms are consistent with the target's original charitable purpose. Moreover, sophisticated bidders can craft their offers to highlight features that support or enhance the target's original charitable purpose. The following are examples of how a bidder can structure its offer to take advantage of these considerations:

- Include a commitment in the asset-purchase agreement to continue and maintain certain key services that are important to the hospital's patients, regulators and other constituents (*e.g.*, emergency room services, OB/GYN services, pediatric services, cancer services, etc.), which can be particularly helpful if the hospital provides health care to an otherwise underserved population;
- Include a commitment in the asset-purchase agreement to spend a certain sum after the closing on doctor recruitment for subspecialties that are underrepresented in the area served by the hospital;
- Include a commitment in the asset-purchase agreement to spend a certain sum after the closing on capital expenditures and other improvements to the hospital; and
- Demonstrate the bidder's financial wherewithal to continue operating the hospital after the closing (as highlighted by the *Hebrew Hospital* case, this can be an important factor in a court's analysis).

The foregoing list is not exclusive. The critical point is that when submitting a bid, a buyer should consider the target's charitable mission, craft its offer in a way that supports or enhances the charitable mission, then highlight those factors with both the seller and the court.

Another strategic point relates to bid protections offered to a bidder that serves as a "stalking-horse purchaser" for a distressed nonprofit hospital. A stalking-horse bidder offer provides an initial bidding floor in a distressed-asset sale and — in exchange for serving in this role — the stalking-horse bidder is often given certain bidding protections, including a break-up fee that is payable to the stalking-horse bidder if the seller ultimately closes the transaction with another party. The break-up fee

8 *Id.* at *701.
9 *Id.*
10 *Id.* at *702. In its thorough discussion of this difficult issue, the court cited, quoted and discussed two articles: Nancy A. Petterman and Sheri Morisette, "Directors' Duties in the Zone of Insolvency: The Quandary of the Nonprofit Corp.," 23 *ABI Journal* (March 2004), at 12, 50; and Gary M. Schildhorn and Brya M. Keilson, "The Unresolved Dilemma of Creditors' vs. Stakeholders' Rights," XXXII *ABI Journal* 4, 58-59, 86, May 2013. Both articles are *available at* abi.org/abi-journal.
11 *Id.* (citing N.Y. N-PCL § 511-a(a)(1)).
12 *In re HHH Choices Health Plan LLC*, 554 B.R. at 702.
13 *Id.* at *704 ("The best I can discern from the case law is that all of these considerations are supposed to be taken into account and balanced in a reasonable way, and with no other requirement or particular weight to be applied.").
14 *Id.* at *710.
15 *Id.* at *714 and 710.
16 *Id.* at *704.

is typically a percentage of the purchase price under the stalking-horse purchase agreement.

In the case of a nonprofit hospital, if part of the stalking-horse purchaser's offer includes binding post-closing financial commitments (*e.g.*, hard commitments with respect to capital expenditures or doctor-recruitment spending), the stalking-horse purchaser has a strong argument that those amounts should be considered, on a dollar-for-dollar basis, for purposes of calculating the break-up fee. For example, if a reasonable break-up fee is 3 percent of the purchase price and the offer provides for a cash purchase price of $80 million with a commitment to spend $20 million on capital expenditures in the 12-month period following the closing, the break-up fee should be 3 percent of $100 million (*i.e.*, $3 million). Even though these post-closing expenditures would not be used to make distributions on account of pre-petition claims, it furthers the charitable mission and inures to the benefit of pre-petition stakeholders (*e.g.*, employees, patients and suppliers).

Conclusion

In a typical § 363 sale process, the bidder offering the highest purchase price is generally selected as the "winning" bidder. However, when the debtor is a nonprofit hospital, the traditional calculus of "highest bid wins" might not apply. Instead, officers and directors of a nonprofit debtor must be mindful of their fiduciary obligations to the debtor's charitable purpose when choosing among potential buyers. This unique aspect of transactions involving nonprofit hospitals creates an opportunity for a well-advised purchaser to structure its proposed transaction in a manner that demonstrates that the charitable purpose will be respected (or enhanced) post-closing. abi

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