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## Medicare/Medicaid Provider Agreements Ruled “Statutory Entitlements”—Not “Executory Contracts”—Thus Limiting a Buyer’s Obligation to Assume Debtor Liabilities in a Bankruptcy Sale

Two important bankruptcy courts recently held that Medicare and Medicaid provider agreements (“Provider Agreements”) constitute “statutory entitlements,” and not executory contracts and, accordingly, could be transferred pursuant to Section 363(f) of the Bankruptcy Code, free and clear of debtor/assignor liabilities. These rulings are contrary to the weight of existing authority and, if this becomes the prevailing legal principle, will provide greater capacity for bankruptcy estates in the healthcare industry to maximize asset sale proceeds as purchasers will avoid assuming government liabilities incurred by debtor/healthcare providers prior to the sale.

In *In re Center City Healthcare, LLC*, the Delaware Bankruptcy Court issued an oral ruling with respect to federally-issued Provider Agreements.<sup>1</sup> In *In re Verity Health System of California, Inc.*, the California Bankruptcy Court addressed this issue with respect to state issued Provider Agreements.<sup>2</sup> The focus of each decision was whether Provider Agreements are executory contracts which must be transferred pursuant to Section 365 of the Bankruptcy Code (inclusive of the debtor’s existing liabilities) or statutory entitlements that may be transferred free and clear of claims under Section 363(f) of the Bankruptcy Code. Both courts used similar reasoning to hold that Provider Agreements were statutory entitlements—not executory contracts—and, thus, could be sold free and clear of debtor liabilities.



## BACKGROUND

In *re Center City Healthcare, LLC* concerned a chapter 11 debtor that sought approval of a sale of a training program for resident physicians that entitled the debtor to Medicare reimbursements under the governing Provider Agreement for each participating resident physician. The Centers for Medicare and Medicaid Services (“CMS”) filed an objection to the sale, arguing, among other things, that, as the Provider Agreement was an executory contract (governed by Section 363 of the Bankruptcy Code), the purchaser was required to assume all of the debtor’s liabilities, including overpayment claims.

In *re Verity Health Systems of California, Inc.*, the Bankruptcy Court addressed objections to the “free and clear” sale of four debtor hospitals operating under Provider Agreements with the California Department of Health Care Services (“DHCS”). At the time of the sale, the debtors owed DHCS millions of dollars for outstanding fees and overpayments. As with CMS in *Center City Healthcare*, DHCS argued unsuccessfully that the Provider Agreements were executory contracts and, therefore, all debtor defaults had to be cured prior to the sale.

## THE DECISIONS

In both cases, the Bankruptcy Courts entered orders approving the sales of the Provider Agreements free and clear of the debtor’s liabilities pursuant to Section 363(f) of the Bankruptcy Code. The decisions noted that executory contracts are contractual in nature, but Provider Agreements are more akin to a statutory right, like a governmental license. Both courts noted that the Provider Agreements did not impose obligations that were not already embodied in controlling laws and regulations. The fact that the government entities reserved the right to make unilateral retroactive adjustments in the Provider Agreements further highlighted the non-contractual nature of the relationship. In effect, the courts reasoned that Provider Agreements were analogous to licenses and, since there was legal precedent that government licenses are personal property interests that can be sold by a debtor under Section 363(f) of the Bankruptcy Code free and clear of liens and claims,<sup>3</sup> these Bankruptcy Courts reasoned that Provider Agreements should be treated the same way.

## CONCLUSION

By providing a legal roadmap for debtors to transfer Provider Agreements free and clear of successor liability obligations under Section 363(f) of the Bankruptcy Code, these two cases, if upheld, could profoundly change the healthcare bankruptcy and acquisition landscape. Assuming the satisfaction of one or more of the conditions specified in Section 363(f)(1)–(5), a purchaser of such entitlements under a Provider Agreement can take such assets without exposure to potential overpayment claims or existing financial obligations owed to the government by the debtor/transferor.

The sale order approved in *Center City Healthcare* is currently the subject of an order granting a stay pending appeal before the Delaware District Court. The court in *Verity Health System of California* denied a motion for an order staying the Hospital Asset Sale on October 22, 2019; the court indicated that it would certify the sale order for direct appeal to the Ninth Circuit Court of Appeals.

Given that these cases represent a significant shift in the law,<sup>4</sup> we expect that CMS and other governmental entities will vigorously challenge these Court rulings and the legal reasoning enunciated therein.



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<sup>1</sup> Transcript Regarding Hearing Held Sept. 5, 2019, *In re Center City Healthcare, LLC, et. al.*, Case No. 19-11466 (KG) (Doc. No. 664) (Bankr. D. Del. Sept. 6, 2019).

<sup>2</sup> *In re Verity Health Sys. of California, Inc.*, No. 2:18-BK-20151-ER, 2019 WL 4729457 (Bankr. C.D. Cal. Sept. 26, 2019).

<sup>3</sup> See, e.g., *MLQ Inv'rs, L.P. v. Pac. Quadracasting, Inc.*, 146 F.3d 746, 749 (9th Cir. 1998).

<sup>4</sup> Prior to these cases, there was some authority that provider agreements could be sold pursuant to Section 363 of the Bankruptcy Code. See *In re B.D.K. Health Mgmt., Inc.*, No. 98-00609-6B1, 1998 WL 34188241, at \*7 (Bankr. M.D. Fla. Nov. 16, 1998).