Business Better (Episode 4): The State of Distress in the Health Care Industry

Speakers: John Wright, John Devine, and Vince Marriott

John Wright:

Welcome to Business Better, a podcast designed to help businesses navigate the new normal. I'm your host, John Wright. For nearly 15 years, I was senior vice president and general counsel at Triumph Group, Incorporated, a global aerospace component supplier. I'm now a member of the securities and M&A groups at Ballard Spahr, a national law firm with clients across industries and across the country. On today's episode, we'll be discussing the current state of distress in the health care industry, and the value opportunities for acquisition, and a consolidation that may arise as a result. We'll explore the drivers of distress and current trends, and how bankruptcy law can be used as a tool for facilitating distressed acquisitions, and realizing upon opportunities for post pandemic healthcare.

John Wright:

To cover these topics, I'm delighted to be joined by my colleagues, John Devine and Vince Marriott, both of whom are partners in the Philadelphia office of Ballard Spahr. John Devine is one of the co-leaders of the firms health care group and advises clients within the healthcare industry on strategic transactions. He also provides advice on federal and state healthcare laws and regulations, including the CARES Act and the Affordable Care Act. Vince Marriott leads Ballard Spahr's, bankruptcy reorganization and capital recovery group. He has extensive experience representing creditors, committees, and other participants in bankruptcy proceedings, and also provide services relating to the purchase of sale of assets in bankruptcy, recapitalizations throughout of court restructurings, and formal reorganizations. John, let's start by talking about the current state of the healthcare industry. How has the healthcare sector been impacted by COVID-19?

John Devine:

So John, first off, thanks so much for having us here today. And as you can expect, the healthcare sector has been significantly and negatively impacted by COVID-19. The American Hospital Association estimates health systems and hospitals alone have lost close to $200 billion from March through June, and the healthcare workforce has decreased by about nine and a half percent from February through April, with about 1.5 million healthcare workers losing their jobs. There was a large-scale elimination of elective surgeries at the beginning of COVID, that's starting to pick back up. There's also been a significant conversion of in-person visits to ... from in-person visits to telehealth visits. That's all led to significant investment from the federal government and tried to bridge the gap during the COVID pandemic.

John Devine:

As we all are aware, the Paycheck Protection Program and the Health Care Enforcement Act allocated billions of dollars in relief across a variety of industries of which $175 billion in relief funds were allocated to hospitals and other healthcare providers. On June 9th, HHS also announced plans to distribute $10 billion to provide a relief fund payment as a safety net to hospitals serving some of the more vulnerable citizens. And in July, HHS, through the Health Resources and Service Administration is announcing approximately $3 billion in funding to hospitals serving a larger percentage of the vulnerable population. So the health care industry has been significantly impacted across all sorts of providers, not just hospitals and health systems.

John Wright:

So when you're talking about providers, you are talking about more than just hospitals, right? Who are the providers you are talking about?

John Devine:

That's right, John. I mean classically when we talk about the health care industry, I think we all just defer to hospitals and health systems, but COVID has impacted the variety of healthcare providers, not only hospitals and health systems, but physician practices, clinics, post-acute care providers, really from the largest of those that provide health care to the everyday physicians and nurse practitioners that we visit for common ailments.

John Wright:

So physician groups and the like are also included in what you're talking about?

John Devine:

Correct. And in many respects, those are some of the most vulnerable populations in the provider network because they have already been leveraged pre COVID. They faced consolidation trends and the like and, in many respects, have continued to [inaudible 00:04:30] as a result of COVID.

John Wright:

So is this a new situation? Was the healthcare sector already in distress before COVID or has COVID been a catalyst or accelerant to the existing distress?

John Devine:

So distress is a bit of a relative term. I wouldn't necessarily characterize the healthcare sector as being in distress, but there certainly was significant movement pre COVID and COVID has just certainly amplified that. Pre COVID, there were a number of financial pressures on providers, again, that spectrum of providers that we just discussed, specifically highlighted by a shift in reimbursement mechanisms from quantitative reimbursement methodologies to qualitative. So a shift in how providers, hospitals, health systems, physician practices manage a population of which they provide healthcare services to. The traditional fee for service model was the more patients you see, the more you get reimbursed. That's now shifting to how healthy is the population that you treat?

John Devine:

That's turned the payer provider mix on its head to a degree, and the actuarial assumptions in financial modeling around utilization and unit price that providers and payers relied upon in formulating reimbursement methodologies were changing as a result of the qualitative shift from quantitative to qualitative reimbursement. And that's now just been completely turned on its head again as a result of COVID, for a variety of factors, most notably, or one significant is disenrollment. As people have lost their jobs or been furloughed, they've come off health plans., and that negatively impacts a physician practice, for example, expectation on what their financial projections will be for the upcoming year.

John Wright:

So I guess those are some of the drivers of the distress in healthcare. Are there other drivers that have effected this?

John Devine:

Sure, John. There's been a number of ongoing drivers that have put some distress on the health care industry, and providers in particular. Bed count and capacity allocation has traditionally been an issue, operating costs and capital expenses for technology. As we've incorporated technology more into the provision of healthcare, it's extremely helpful and creates efficiencies, but it comes at a cost, especially in initial capital costs. There's been ongoing competition in markets. You just look at what the Philadelphia healthcare sector has looked like over the past and how it's changed over the past decade in particular. Competition breeds consolidation. And, as previously discussed, reimbursement levels are always going to impact how providers are looking to take advantage of a new reimbursement methodology, and that always creates opportunities for reimbursement.

John Devine:

COVID related drivers to distress also includes substantial loss of revenue, as to be expected. The less number of patients that are flowing through the healthcare system leads to a substantial loss of revenue, and then increased costs as a result of the need for protective equipment to treat COVID, hazard pay, and overtime, and again, increased costs for technology during COVID have led to additional distress. And lastly, as I mentioned, the workforce is just decreasing. That number I provide at the beginning, about 1.5 million healthcare workers have lost their jobs during COVID, that number continues to increase.

John Wright:

So to what extent was consolidation taking place in the healthcare sector pre pandemic, and how have these pre pandemic consolidation trends continued during the pandemic?

John Devine:

Sure. So pre pandemic, there were a number of different factors that were impacting enhanced consolidation. Now, we talked previously about factors of distress, those carried through and are impacting or influencing consolidation pre COVID. They included reimbursement pressure and complexity that I talked a little bit about previously, there's been an increased reliance on managed care, a push to reduce cost and cost efficiencies, and also how that has led to increased costs related to technology advancements. So those are two factors that are pulling against each other. Technology advancements in particular, it's one of those things that we continue to talk about in the healthcare sector. Technology is incredibly useful, especially during the pandemic, and we expect it to be an enhanced factor for the manner in which people receive care moving forward, but it's also led to enhanced integration and consolidation. Taking also into consideration that we have an aging baby boomer population, one of the biggest generations of people that are going to need to have continued access to healthcare. There's also been substantial increase in access to capital.

John Devine:

So whether it's large hospitals and health systems that have robust balance sheets, or private equity investment or the like that have dry powder that are able to invest into healthcare technologies, that's all been factors that have led to pre COVID consolidation. That trend has continued though during COVID as it relates to the distress factors that we talked about previously. So there's been substantial stress put on the health care sector as result of COVID, increased cost, access to bed counts and capacity allocation. That's led a number of organizations and providers across the spectrum to suffer financial distress during COVID. That's created opportunities for those that are in a healthy position to take advantage of that distress to acquire assets and enhance consolidations. So those organizations that have access to capital, whether it be equity or debt, or hospitals, again, that have a very healthy balance sheet, larger provider networks that have a healthy balance sheet to take advantage of those distressed assets. So we expect the consolidation to continue and actually be amplified as a result of COVID, and continue the trend and continue coming out of COVID.

John Wright:

So I think you've already started to allude to it, but who are the players that are in the best position to capitalize on these distress situations?

John Devine:

Sure. Again, it's those that have access to capital, those that have a great infrastructure that reaches both regionally and nationally, those organizations that have been able to retain a workforce. One of the biggest things that we keep on going back to, I mentioned that the $1.5 million ... excuse me, 1.5 million healthcare workers that have lost their jobs, to the extent that physician practices, providers, post-acute care providers, hospitals and health systems that have been able to retain a workforce through COVID and coming out of COVID, they're going to be in the best position to capitalize on the need for healthcare moving forward. We are always going to need healthcare, it's going to be amplified as a result of COVID. Those with access to capital and a large workforce, I think, are going to be in the best position to capitalize on consolidation coming out of COVID.

John Wright:

And we're using the word consolidation, I take it that in most cases, what we're really talking about are acquisitions of one sort of provider by one of these players, either private equity, or another health system, or the like. Is that right?

John Devine:

Generally, that's right, but acquisitions, consolidation, and integration, key buzzwords that we use in any kind of M&A context, can take many different forms, whether it be through acquisition of assets, or distressed assets on the balance sheet through a bankruptcy proceeding, an arms length merger, or a joint venture. We're seeing enhanced joint venture opportunities where partners are looking to consolidate assets, and utilize their best resources to combine and deliver healthcare, whether that be a managed care organization that has access to a large technology platform or a hospital and health system that's looking to leverage its large EHR system to consolidate across regions and nationally.

John Wright:

Great. Thanks, John. So Vince, once these potential acquirers identify opportunities for acquisition in healthcare, what are their options?

Vince Marriott:

John, let me start by identifying two of the key variables that need to be considered in assessing options, and they pull in opposite directions. Distressed entities typically have both operational, such as unfavorable contracts, and balance sheet, such as over leverage issues, creating what is often referred to as a melting ice cube situation. The time to assess these issues, move forward, and then address these issues is often short. Not a lot of runway, to use another common phrase. At the same time, however, the exact nature and extent of the operational and balance sheet issues, and the implication of those issues for a potential acquirer may not be readily ascertainable, and reduction in the risk of post acquisition liability exposure and other surprises may require a comprehensive time-consuming and expensive due diligence. So the competing variables in assessing options include moving quickly enough to stop the melting before it is too late while at the same time managing the risk of known and unknown liabilities, and other potential exposure for the acquirer.

Vince Marriott:

So there are really two principle options for approaching the acquisition of a distressed enterprise, each of which prioritizes one or the other of these two variables while also offering other distinct advantages and disadvantages. Both involve an asset acquisition, there is rarely any reason to consider an equity acquisition, but one is a transaction conducted outside of a court proceeding and the other is a transaction conducted in the context of a court proceeding, most commonly, for a variety of reasons, a sale in a bankruptcy proceeding under section 363 of the United States bankruptcy code.

John Wright:

Well perhaps it would be useful to break these options down a bit and outline their advantages and disadvantages. First, what are the advantages of an out of court transaction?

Vince Marriott:

John, there are a number of advantages. First, speed. The transaction can move as quickly as the parties to the transaction are prepared to make it happen, which helps address the melting ice cube problem. Second, exclusivity. Out of court, the potential buyer can require that as long as negotiations are ongoing with the seller, other potential buyers will not be sought or negotiated with so that price escalation from a competitive situation is avoided. Third, there is the absence of required third party involvement in negotiations. Nobody else, at least formally, has a seat at the table, whereas in a bankruptcy proceeding, for example, both creditors and ultimately the court will have a say in the terms of any sale. Fourth, there is potentially lower costs and transactional uncertainty associated with an out of court transaction. Transactional efficiency and certainty is enhanced when the parties control the speed of the transaction and the scope of third party involvement.

John Wright:

Great. And what are the disadvantages of an out of court transaction?

Vince Marriott:

First and most significantly, exposure to the risk of unknown or unavoidable legacy liabilities, either because of statutory or common law successor liability, which can arise even though it's an asset sale, or because of a challenge to the ultimate purchase price as inadequate under a fraudulent transfer or similar theory. This risk can be mitigated, but not eliminated, by comprehensive due diligence and, if available, representation warranty insurance, but either will impact the speed of the transaction and the cost. I should mention that in theory, indemnities could be included, but with a distressed entity, they aren't worth much absent an escrow, which will often not be practical, and even if it is, will be in a limited amount for a limited time. The second disadvantage is that although formal involvement of third parties, such as creditors or a court, may not be required as a practical matter, such involvement may become necessary. For example, because there are liens on the assets that will have to be released or because critical contracts contain anti-assignment provisions so that consents will be required from the contract counterparties.

John Wright:

So the alternative you mentioned was a section 363 sale. What are the advantages of a section 363 sale in a chapter 11 bankruptcy proceeding?

Vince Marriott:

I'll start by observing that, in many respects, the advantages and disadvantage of a section 363 transaction are mirror images of an out of court transaction. The first and perhaps principle advantage of a section 363 transaction is the limitation of the risk of exposure to legacy liabilities and later attempts to unwind the transaction for insufficient consideration or otherwise. A sale under section 363 by statute is free and clear of all liens claims and encumbrances, and will cut off most successor liability and avoidance action exposure. This will also reduce the need for comprehensive due diligence, at least with respect to the balance sheet. The second principle advantage is that lien holder and contract counterparty consent are not necessary to strip liens or assigned contracts. Both can be accomplished by operation of law.

John Wright:

And finally, what are the disadvantages of a section 363 sale?

Vince Marriott:

I would say first, the requirement to solicit competitive bidding. Under section 363, a seller must market the assets and seek higher and better bids as part of an auction process. This exposes the potential acquirer to the risk of a material increase in the acquisition price if it wants to proceed with the transaction. Second, there is delay. The marketing competitive bidding process takes time, and during that time, the ice cube may be continuing to melt, although perhaps less quickly due to the automatics stay and other bankruptcy provisions. Third, there will be creditor involvement in the negotiations and the requirement for court approval of the ultimate transaction. Even in the absence of competitive bidding, this can result in terms less favorable to the potential acquirer than would otherwise be the case and can further delay closing of the transaction.

John Wright:

Thanks Vince. Well, we probably should wrap this episode up, but before we go, I'd like to ask each of you to briefly review the key tips or takeaways you'd want our listeners to remember. Let's start with you, John.

John Devine:

Again, thanks John. I think some of the key takeaways as it relates to opportunities coming out of the pandemic are that buying opportunities are going to arise from distress. There's going to be potential for significant value enhancements as current economic crisis has and will continue to impact valuations in general as well, and operators that lack cashflow runway will be forced into distressed sales. What's important though to remember is that time matters. Buyers should be prepared to take advantage of this market. They should have a comprehensive and prioritized due diligence tracker, should have resources already devoted to diligence, and constantly enhance regular communications across the network to ensure efficiency and speed to market. And lastly, diligence matters. As distressed sellers may be unwilling to provide meaningful representations in sources of recovery, there's going to be a lot of as is transactions, so make sure you do your diligence and engage with your counselors to evaluate the assets that you're buying.

John Wright:

So Vince, what are your key takeaways for our listeners?

Vince Marriott:

I earlier mentioned two competing variables, speed and legacy liability exposure risk. I'll also add a third, exclusivity and controlling the prospect of an escalating price. The potential acquirer must very early on decide which of these variables to prioritize, since it will determine which type of transaction format should be pursued. I should also add that if an out of court transaction is chosen, the potential acquirer will need to quickly develop and implement a comprehensive plan of due diligence to mitigate the legacy liability risk.

John Wright:

Thanks. Finally, if any of our listeners would like to follow up with questions or get in touch, how can they best reach each of you? John?

John Devine:

So best way to reach me, John, is through my email, and that's devinej@ballardspahr.com.

John Wright:

And Vince?

Vince Marriott:

John, I can be reached via email. My email is marriott@ballardspahr.com.

John Wright:

Great. Well, thanks again to you both for joining us on Business Better. Make sure to visit our website, www.ballardspahr.com, where you can find the latest news and guidance from our attorneys. Subscribe to the show in Apple podcasts, Google Play, Spotify, or your favorite podcast platform. If you have any questions or suggestions for the show, please email podcast@ballardspahr.com. Stay tuned for a new episode coming soon. Thank you for listening.