Financially Distressed Rural Healthcare Organizations
Trends, Issues To Be Aware Of, and Strategies


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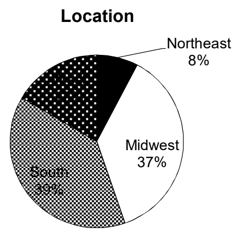
Overview

- Rural Hospital Closures
- Zone of Insolvency and Related Legal Issues
- Strategies When Under Distress

Rural Hospitals Today

- 2,322 rural hospitals in the United States

Rural Hospitals Today



Rural Hospitals Today

- Medicare Reimbursement
  - 53.5% - Critical Access Hospitals
  - 14.5% - Medicare PPS hospitals
  - 13% - Sole Community Hospitals
  - 11% - Rural Referral Centers
  - 8% - Medicare Dependent Hospitals

Significant Events

- 1946 – Hill-Burton Act
- 1983 – Prospective Payment System
- 1997 – Introduction of “critical access hospital” and other enhanced payment models
- 2008 – The Great Recession

Trends

- Rural Hospitals Closures from 2005 through 2017
  - 122 rural hospital closures in total
  - 10 closures per year on average
  - 2.4 closures per state on average
  - “closure” defined as cessation of inpatient services
- Kentucky – 5 closures
- 2013-2017 – 13 closures per year

Trends

- Geographic Location
  - South – 60% (includes Kentucky)
  - Midwest – 18%
  - West – 12%
  - Northeast – 10%
- Size
  - 1-25 beds – 53%
  - 26-50 beds – 25%
  - >50 beds – 22%

Trends

- Factors contributing to closure
  - Lack of Employment
  - Folks going elsewhere for healthcare
  - Reimbursement Challenges
  - Competition
  - Inadequate physician coverage
  - Aging plant and equipment
  - Excessive organizational debt

Trends

- Medicaid Expansion as a Factor in Closure
  - 18 states that ***HAVE NOT*** expanded Medicaid
    - 77 hospital closures
    - 4.27 per state
  - 33 states that ***HAVE*** expanded Medicaid (including D.C.)
    - 45 hospital closures
    - 1.36 hospital closures per state

Trends

- Will the trend continue?

Trends

- Financial Distress Index (FDI)
  - North Carolina Rural Health Research Program
- Predicts the risk of "distress" within the next 2 years
- Distress means
  1. Unprofitability = negative cash flow margin in 1 year
  2. Equity Decline = at least 20% equity decline over 2 years
  3. Insolvency = total liabilities exceed total assets
  4. Closure = cessation of inpatient care

Trends

- Based on 12 predictors, hospitals are assigned a risk level that suggests the likelihood of experiencing a distress event in next 2 years.
  - 4 risk levels
    - low
    - mid-low
    - mid-high
    - high

Trends

- 12 predictors in the following areas:
  - financial performance
    - change in operating margin, rate of equity reinvestment
  - hospital characteristics
    - size based on volume, ownership status (for-profit or non-profit)
  - government reimbursement
    - CAH, PPS, etc.
  - market characteristics
    - miles to nearest competitor hospital, population size, poverty rate

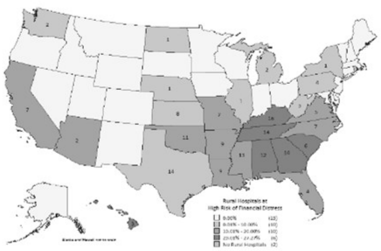
Trends

- Example of a high risk rural hospital:
  - small
  - located close to several competitor hospitals
  - located in an area of low population and high poverty
  - recent history of negative margin and no equity reinvestment
  - PPS reimbursement

Trends

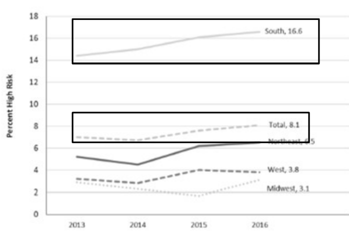
- 2016, # of High Risk Hospitals (predicting for 2017-18)

- 181 hospitals at high risk
- 8.1 % of all rural hospitals
- Kentucky had 16, which was the highest nationwide



Trends

- 2013 through 2016, # of High Risk Hospitals



Trends

- 2017, # of High Risk Hospitals (predicting for 2018-19)

- 197 hospitals at high risk
- 8.8 % of all rural hospitals
- Kentucky had 11

Issues to Be Aware Of

- Company Structure
- Management and Shareholder Liability
- Zone of Insolvency

Zone of Insolvency

- Fiduciary Duties
  - Solvent Corporation → the Corporation; its Stockholders
  - (near) Insolvent Corporation→ add Creditors

Must balance conflicting interests, avoid personal liability for officers and directors.

Zone of Insolvency

- Fiduciary Duties (Generally)
  - Duty of Care
    - obligation to act on an informed basis
  - Duty of Loyalty
    - obligation to act in best interests corporation, and not in self-interest
  - Duty of Good Faith
    - obligation to maintain, in good faith, corporation's and its shareholders' best interests over anyone else's interests

Zone of Insolvency

- Fiduciary Duties (Generally)
  - Business Judgment Rule
    - "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interest of the company".
    - "A rule of law that insulates an officer of a corporation from liability for a business decision made in good faith if he is not interested in the subject of the business judgment, is informed with respect to the subject of the business judgment to the extent he reasonably believes to be appropriate under the circumstances, and rationally believes that the business judgment is in the best interests of the corporation."

Zone of Insolvency

- What is the Zone of Insolvency?
  - Difficult to Pinpoint
  - Not Necessarily Insolvent

Zone of Insolvency

- Early Warning Signs of Financial Distress
  - Flat or decreasing top line revenue growth
  - Uncompetitive on quality, pricing, costs
  - Strategies executed successfully, but results still deteriorating
  - Inability to fund strategic needs, renew asset base, invest in required systems and capabilities, *even if* cash flow is positive
  - Tightening constraints: regulatory, financial, competitive, human resources, clinical, and operational

Zone of Insolvency

- Two Tests
  - Equity Test
    - When a corporation is unable to pay its debts as they come due in the ordinary course of business
  - Balance sheet Test
    - When liabilities exceed reasonable market value of assets held

Zone of Insolvency

- Director Considerations
  - Must do's to avoid Personal Liability
    - begin considering duties under zone of insolvency early
    - ensure all transactions are:
      - entered in good faith
      - fair and reasonable
      - free from self-dealing or favoritism towards any group of stakeholders

Issues to Be Aware Of

- Entity Level Taxes that Impose Personal Liability on Officers of the Entity

1. Kentucky Healthcare Provider Tax
2. Withholding on Wages (state and federal)
3. State Sales and Use Tax

Issues to Be Aware Of

- Kentucky Healthcare Provider Tax, KRS 142.301 *et seq.*
  - assessed on 12 different types of health care organizations
    - hospitals, MCOs, nursing facilities, etc.
  - helps to fund Kentucky Medicaid programs
  - for hospitals, tax is equal to 2.5% of gross revenues
  - tax is paid monthly

Issues to Be Aware Of

- Personal Liability, KRS 142.357
  - Who?
    - the president, vice president, secretary, treasurer
    - or any other person holding any equivalent corporate office
    - person must have authority in the management of the business or financial affairs of the corporation
  - When?
    - liability attaches when taxes became due
  - To What Extent?
    - personal and individual liability, joint and several
    - not absolved by corporate dissolution or cessation of holding corporate office

Issues to Be Aware Of

- Wage Withholdings
  - State
    - KRS 141.340 – sets forth personal liability scheme identical to healthcare provider tax for any state taxes required to be withheld on wages paid to employees of an entity.
  - Federal
    - 26 USC 6672 – similarly imposes personal liability for any "person" who "willfully fails to collect … and pay over" any federal income tax.
    - "person … includes an officer or employee of a corporation, or a member or employee of a partnership, who … is under a duty to [withhold the tax]"

Issues to Be Aware Of

- State Sales and Use Tax
  - KRS 139.185 – again, sets forth personal liability scheme identical to healthcare provider tax for state sales and use tax
  - Sales Tax – pharmacy, cafeteria, gift shop, etc.
    - applicable to most entities that sell any goods to individuals
  - Use Tax – e.g., hospital orders beds from out-of-state and vendor isn't required to collect use tax, so hospital must report and pay it
    - back stop to sales tax for out of state vendors
    - usually not applicable to tax-exempt entities

Issues to Be Aware Of

- Key Distinctions
  - With wage withholding and sales and use tax, the activity that triggers the tax creates a fund with which to pay the tax.
  - However, the healthcare provider tax, which is on gross revenue, does not create such a fund; the tax applies to $1 of revenue even if it took more than $1 to generate that revenue.
  - In other words, hospitals that operate losses still owe the healthcare provider tax, which makes the personal liability feature especially worrisome.

Issues to Be Aware Of

- But none of this matters to individual employees and officers unless taxing authorities actually enforce personal liability on these taxes.
- Do they?

Issues to Be Aware Of

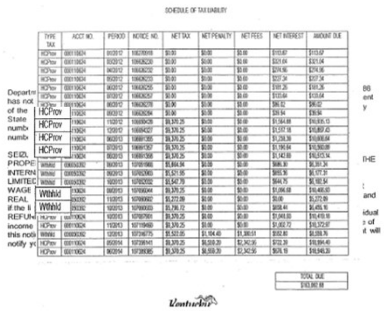
- Facts
  - Struggling hospital in Kentucky
  - Hospital eventually forced to choose between:
    a. paying for life-saving drugs, emergency room physicians, vital diagnostic services, and other essential costs of care, or
    b. paying monthly healthcare provider tax and state wage withholdings
  - Hospital eventually filed for bankruptcy

Issues to Be Aware Of

- Facts (continued)
  - Hospital ended up with
    - unpaid Healthcare Provider Tax,
    - unpaid state wage withholding, and
    - related penalties and interest
  - Total tax liability in excess of $160k
  - Debt was not discharged in bankruptcy

Issues to Be Aware Of

- Who would be liable?
- Which corporate officers had authority in the management of the business or financial affairs of the corporation?



SCHEDULE OF TAX LIABILITY

TYPE TAX	ACCT NO.	PERIOD	NOTICE NO.	NET TAX	NET PENALTY	NET FEES	NET INTEREST	AMOUNT DUE

TOTAL DUE

Issues to Be Aware Of

- Arguments We Made
  - Not a corporate officer
  - Lacked authority to pay the taxes under the organization's articles of incorporation
  - Liability should be shared among all officers
  - Fairness and Policy
    - employees should not be punished for staying on board
    - provider tax is not a self-sustaining tax

Strategies

- Evaluate Alternatives Early
- Conduct Fair and Thorough Process
- Utilize Best Practices
- End-of-Life-Cycle Considerations/Options

Strategies

- Importance of Evaluating Potential Alternatives
  - Defer the discussion
    - continue operating at a loss
    - rising debt loads
    - aging physical plants, deferred maintenance, delay of upgrades
    - physician and employee attrition
  - Proactive
    - better opportunities to shape transition (e.g. Affiliation v Acquisition)
    - higher likelihood for multiple offers
    - negotiate from position of strength to obtain commitments for benefits and continuity of care to the community
    - understand risk profiles of options

Strategies

- A Fair and Thorough Process
  - Actions that increase stockholder return at the expense of creditor's rights should be considered carefully
  - Avoid dividends or stock redemption (or anything else that would impair creditors while giving preferential treatment to stockholders)
  - Avoid giving preference to once class of creditors over another
  - Due Diligence is key. Decisions will be reviewed in hindsight in light of the effect of such actions on corporation in its entirety

Strategies

- A Fair and Thorough Process (Con't)
  - Avoid transactions that may be viewed as fraudulent conveyance (i.e. preferential treatment of one stakeholder over another)
  - Propose at each annual stockholder meeting a resolution affirming that all business decisions taken by the directors and officers of the corporation were taken in good faith after an exercise of reasonable care.
  - Avoid appearance of conflict of interest
    - engaging in self-dealing would be a violation of duty of loyalty
    - fully disclose all personal or business relationships with parties on the other side of transactions involving the company

Strategies

- A Fair and Thorough Process (Con't)
  - Evaluate potential fund raising or sale transactions –those transactions may be scrutinized later in light directors' expanded fiduciary duties (including creditors)
  - Note that resignation does not provide total protection
    - director will continue to have liability for pre-resignation acts and omissions
    - director has duty not to resign if resignation will cause immediate harm, allow harm to occur, or leave corporate assets unprotected

Strategies

- Best Practices
  - Purchase Price (sufficient to pay all Seller obligations to Third-Parties?)
  - Due Diligence
  - Representations and Warranties Indemnity and escrows

Strategies

- Director & Officer Insurance
  - Insures against financial losses, including cost of litigation incurred by the insured
  - Typically contains two parts:
    - 1) reimburses corporation for amounts that it pays to indemnify officers and directors for covered losses;
    - 2) directly insures officers and directors to the extent that there is no corporate indemnification, or that available corporate indemnification does not cover the loss incurred
  - Review policy prior to entering zone of insolvency
    - Consider effect of resignation
    - Tail insurance for claims made policy?

Strategies

- Affiliation/Consolidation
  - Contractual
    - Joint Operating Agreement
    - Joint Venture
    - Hospital Lease
    - Management Agreement
  - Who is in charge?
  - Who gets hurt?

Strategies

- Sale
  - Asset or Stock?
- Merger
  - Reps and warranties?
  - Focus on indemnities
  - Public property?
  - Fraud and Abuse considerations?
  - Anti-trust?

Strategies

- Downsizing and/or Repurposing
  - Shut down unprofitable segments?
  - Restrict services to provide limited, non-inpatient services
  - Effect on community?

Strategies

- Liquidation/Closure
  - Loss of lines of care in community?
  - What to do with Medical Records?
  - Continued Liability?

Strategies

- Worker Adjustment and Retraining Notification ("**WARN**") Act
  - Federal law designed to protect workers and their families
  - Requires "covered employers" to provide notice 60 days in advance of "closing employment sites" and "mass layoffs"
  - Only if requisite # of employees experience "employment loss"
  - Applies to private, for-profit and nonprofit employers, as well as public and quasi-public entities.

Strategies

- What is a "covered employer"?
  - Employer w/ 100 or more employees, excluding employees who have worked less than 6 months during the past year.
  - Part-time employees are not counted unless their weekly hours, in aggregate, exceed certain thresholds
  - Temporary employees are counted (but are not entitled to receive notice)
  - # of employees determined as of the date notice would be due

Strategies

- What scenarios trigger notice?
  1. Closing Employment Site
     - Notice is required upon shutdown of any employment site (or any facility or operating unit within the employment site) that results in “employment loss” of 50 or more employees
  2. Mass Layoff
     - any layoff of at least 500 employees, and
     - any layoff between 50-499 employees, if the # of employees laid off is at 33% of the employer's active workforce.

     *notice required even if no site or facility is closed

Strategies

- What is “employment loss”?
  - termination of an individual’s employment for any reason other than discharge for cause, voluntary departure or retirement
  - a layoff of more than 6 months, and
  - a reduction in hours of more than 50 percent for 6 consecutive months

Strategies

- Rolling Window
  - The WARN Act looks to the number of employment losses occurring in any rolling 30-day period.
  - Example – if an employer with 100 employees laid off 30 workers on day 1 and laid off another 30 workers on day 25, the WARN act would apply and notice would be required for all 60 employees (assuming they constitute greater than 33% of active workforce).

Strategies

- Who is Notice Given to?
  1. chief elected officer of the bargaining agency(s) of affected employees;
  2. unrepresented individual workers expected to suffer employment loss;
  3. the state dislocated worker unit (next slide); and
  4. the chief elected official of the unit of local government in which the employment site is located.

Strategies

- In Kentucky, the state dislocated worker unit is the Kentucky Division of Workforce and Employment Services (502-782-3252).

Strategies

- Content of Notice – Notice to individual workers:
  1. A statement as to whether the planned action is expected to be permanent or temporary and, if the entire plant is to be closed, a statement to that effect;
  2. The expected date when the plant closing or mass layoff will commence and the expected date when the individual employee will be separated;
  3. An indication whether or not bumping rights exist;
  4. The name and number of a company official to contact for further information.

Strategies

- Content of Notice
  - No particular form of notice is required. However, all notices must be in writing.
  - Any reasonable method of delivery designed to ensure receipt 60 days before a closing or layoff is acceptable.

Strategies

- Exceptions to Notice Requirement
  1. Faltering Company Exception
     - company is seeking new capital or business in order to stay open and giving notice would ruin the opportunity to get the new capital or business; **applies only to plant closings*
  2. Unforeseeable Business Circumstances Exception
     - applies to closings and layoffs that are caused by business circumstances that were not reasonably foreseeable at the time notice would otherwise have been required
  3. Natural Disaster Exception
     - closing or layoff is the direct result of a natural disaster, such as a flood, earthquake, drought or storm

Strategies

- Exceptions to Notice Requirement
  - If an employer provides less than 60 days advance notice pursuant to one of the exceptions, the employer bears the burden of proof that the exception was met.
  - The employer also must give as much notice as is practicable.
  - When notice is pursuant to an exception, it must include a brief statement of the reason for reducing the notice period.

Strategies

- Penalties
  1. Liable to each employee for back pay and benefits for the period of violation, up to 60 days
     - Payments you are legally obligated to make do not count towards satisfying penalties, meaning essentially you pay twice for 60 days
  2. Civil penalties not to exceed $500 per day for period of violation, and
  3. Attorneys fees
- Individual Suits and Class Actions

Strategies

- Mini WARN Act? Not in Kentucky.

Questions?

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