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BANKRUPTCY LAW

Prognosis Negative

Is bankruptcy court the cure needed for distressed New Jersey hospitals?

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The financial woes of New Jersey hospitals have now spilled over to the bankruptcy courts through a number of recent Chapter 11 filings. With four hospital closures in 2007, and four more either filing for bankruptcy or announcing plans to close, the future is not promising for many New Jersey residents needing hospital-provided health care services. Against this backdrop, bankruptcy courts, hospitals, their creditors and other interested parties have struggled to find a methodology for working through these problems.

According to a report of the New Jersey Hospital Association (NJHA) released in November 2007, on an aggregate basis, New Jersey hospitals operate at a very narrow margin. Total revenue for all of the state hospitals in 2006 was at $17.13 billion and operating costs totaled $17.02 billion. The operating margins have been on the decline for a number of years. This trend is unlikely to be reversed in the near term. According to NJHA, 40 percent of New Jersey hospitals are actually operating at a loss.

Financial problems leading to bankruptcies and closures are attributable to many factors, including insufficient reimbursement from Medicare and Medicaid, insufficient contributions from the state's charity care program, which requires hospitals to provide care to all regardless of the ability to pay, as well as increased competition from physician-owned private ambulatory centers that attract high-margin patients. These challenges are unlikely to abate in the near future, making additional bankruptcy filings more likely. However, hospitals seeking Chapter 11 protection face many obstacles that may diminish, rather than augment, a hospital's chance of survival. The bankruptcy courts that oversee the cases are often hamstrung due to the unique nature of hospital cases. Before seeking Chapter 11 protection, a hospital should consider all available options and Chapter 11 should truly be the option of last resort.

Most New Jersey hospitals are organized as not-for-profit corporations managed, in general, by boards of trustee whose board members, in many instances, have received little training in hospital oversight or state fiscal or clinical regulations. (New Jersey has recently added a requirement that members of a hospital board receive training.) A not-for-profit hospital is founded on a charitable mission of providing health care to the community. Its federal tax-exempt status is dependent upon its providing a community benefit while operating an emergency room that provides care to patients without regard to their ability to pay.

The Bankruptcy Code precludes the filing of an involuntary petition against a not-for-profit entity. Accordingly, a typical New Jersey hospital does not face the threat of creditors joining to file an involuntary bankruptcy petition against it. This is good, because many social and economic considerations suggest that any bankruptcy, voluntary or involuntary, is not the best option for an insolvent hospital. In a bankruptcy case, creditors have defined roles and representation through the mechanism of the creditors' committee, while the community the hospital serves does not. Unlike the shareholders of a for-profit corporation who have the opportunity to form an equity holders' committee in a bankruptcy case, members of the community, who are the stakeholders of a nonprofit hospital, typically have no similar committee and group representation. In addition, the costs of administration of a bankruptcy case increase the financial burden on the distressed hospital. A Chapter 11 petition initiates a costly round of professional fees for the debtor's professionals as well as the fees of counsel and financial advisors for the creditors' committee.

Further, in many instances, the specter of bankruptcy makes it much more difficult for hospitals to attract

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patients and retain and attract qualified health care personnel. The rumors of financial problems and bankruptcy can cause physicians to seek privileges and refer their patients elsewhere. Doctors increasingly obtain admission privileges at multiple hospitals, which gives them more flexibility. Inadequate staffing in key departments may leave little choice but to close selected departments, or in some cases the entire hospital. While the bankruptcy court may be an adequate forum to address the purely financial aspects of a distressed hospital, it should not be its role to determine which communities should have acute care hospitals and which should not.

Section 109 of the Bankruptcy Code defines who can be a debtor, and provides that a not-for-profit hospital is eligible for Chapter 11 protection. In fact, Congress enacted recent amendments to the Bankruptcy Code to address hospital bankruptcy situations.

Despite the fact that Congress allows not for-profit hospitals to seek Chapter 11 relief, bankruptcy courts presiding over hospital cases face significant challenges, because certain of their powers are limited by statute and precedent applicable in hospital bankruptcy cases. A basic tenet of bankruptcy law is that the Chapter 11 debtor has a duty to maximize value for the estate and its creditors. In exercising this mandate, bankruptcy courts have the power to compel the liquidation of a business if there are continuing losses and when a liquidation will benefit all creditors. In most cases, bankruptcy courts routinely apply these principles to adjust millions, if not billions, of dollars of debt.

In hospital cases, however, the bankruptcy court's ability to discharge these mandates is often burdened by societal concerns — the bankruptcy court is put in a position where not just dollars or jobs are at issue. As a result, in the context of certain actions, the bankruptcy court must also take into consideration the fact that a debtor is a charitable institution providing critical medical services to a community which can make a difference between life and death. For example, in the context of asset sales, a bankruptcy court is obligated to entertain higher and better offers, which means that the bankruptcy court may not focus solely on price. That is, in certain cases (and often hospital cases), a court may find a lower bid better when other factors are involved, including societal needs, such as maintaining a hospital in the community as opposed to converting the land and facilities to a different use.

Although bankruptcy courts may take societal needs into consideration, they are not allowed to determine who can operate a hospital in New Jersey since that decision rests solely with the state's Commissioner of Health and Senior Services. Therefore, a bankruptcy court is constrained in selecting a "highest and/or best" bidder because the ultimate decision of hospital operation rests with the State of New Jersey.

Another limitation is that the bankruptcy court, as a non-Article III court, must contend with the principles of comity and abstention, which prevent a bankruptcy court from interfering with matters of state law. Further, a bankruptcy court is powerless to compel the liquidation of a not-for-profit hospital by operation of section 1112(c) of the Bankruptcy Code without the hospital's consent. In addition, the bankruptcy court is unable to force a New Jersey hospital to shut down because that decision, once again, rests solely with the Commissioner of Health and Senior Services.

Faced with these inherent limitations, bankruptcy courts are simultaneously required to adjust millions of dollars of debts and balance the interests of classes of creditors with competing interests, while being cognizant of the fact that its decisions may have immediate impact on the community's ability to readily obtain critical medical care. The difficulty of this charge is magnified by the fact that most hospitals seeking Chapter 11 protection are losing money on a daily basis and a quick restructuring is often difficult, if not impossible.

A not-for-profit hospital with an experienced management team might better serve its charitable mission, its patients, the community and its creditors by using its resources outside of bankruptcy to develop a restructuring plan through negotiation with its major creditors and state regulatory and financing authorities. To the extent a restructuring plan is not a viable option, management could explore the possibility of a strategic alliance or sale of the hospital. Bankruptcy may then be an appropriate option if the potential purchaser insists on acquiring the assets of the hospital free and clear of old debts through a bankruptcy auction. Finally, if neither a turnaround plan nor a sale can be achieved, the hospital may formulate a plan of orderly closure in close cooperation with the state department of health that licenses and regulates the hospital's health care activities. The state regulators are better equipped to supervise and achieve an optimal outcome for all concerned parties if they, rather than a bankruptcy court, supervise the initiation, timing and critical decision-making that must occur in connection with the closure of a hospital.

Further, the legislature should address the problems that currently face the hospitals through new policy initiatives to prevent further involvement of the bankruptcy court, which has been called upon to solve a state policy problem without the jurisdiction or tools necessary to formulate a solution. As we are seeing, innocent creditors and the affected communities bear the repercussions of this situation and become the biggest losers in the process.

In short, the undertaking of solving the New Jersey health-care crisis should not be shifted to the bankruptcy court, creditors and parties in interest. Market forces should be allowed to operate to enable the strongest healthcare systems to survive, but those forces need to work in an efficient and equitable system that coordinates both legislative and judicial functions and is tailored to the particular challenges facing not-for-profit hospitals. Until such a system is in place, the health-care crisis in New Jersey will continue and so will the concomitant burdens on the bankruptcy system. ■