

# Rural Focus

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## Bankruptcy as a Path Forward for Distressed Rural Hospitals

By Tom Waldrep, Jennifer B. Lyday, and Jim Lanik, Partners,  
*Waldrep Wall Babcock & Bailey PLLC*

*This article is part four in a series on the importance of hospital and health system boards assessing their strategic risk profile and taking action when their organizations are distressed. Part one provided a framework for evaluating risk, part two covered quantifying risk and identifying signs of stress, and part three highlighted the duties of board members in potentially distressed organizations.<sup>1</sup>*

Rural hospitals strive to continue to provide appropriate care for their communities despite strong healthcare industry headwinds. However, some rural hospitals cannot make ends meet and may need some sort of financial intervention. Restructuring—or bankruptcy—is an important tool for struggling organizations to regain viability and preserve their mission. The goal is to avoid closure, maintain local access to services, reestablish solvency, and chart a sustainable path forward. As with any strategy, timing and execution are key to a good outcome.

### Will Bankruptcy Help a Distressed Rural Hospital?

Bankruptcy<sup>2</sup> can help rural non-profit and for-profit hospitals address significant financial constraints. Often, these financial problems build gradually over the years. While there are management and strategic interventions that can forestall or mitigate financial distress if undertaken proactively,<sup>3</sup> this article focuses on how bankruptcy can address the financial problems of distressed rural hospitals. A bankruptcy reorganization can provide debtors with mechanisms to restructure payments to creditors, re-amortize or refinance debts, and in some instances, discharge liabilities.

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- 1 Jeff Sommer, Jennifer Lyday, and Clare Kelly, “Proactively Assessing Your Organization’s Strategic Risk Profile,” Rural Focus, The Governance Institute, December 2023; Jeff Sommer and Clare Kelley, “Quantifying Risk and Identifying Signs of Stress in Your Organization,” Rural Focus, The Governance Institute, April 2024; James Wall and Cassidy Willard, “The Duties of Board Members in Potentially Distressed Organizations,” Rural Focus, The Governance Institute, June 2024.
  - 2 The Bankruptcy Code is federal law, applicable in all 50 states, and can be found at 11 U.S.C. § 101 et seq.
  - 3 See [previous articles in this series](#).

The net effect of restructuring can be to greatly reduce the financial liabilities of a distressed organization. Bankruptcy provides the organization with an automatic stay against (i.e., a “breathing spell” from) pending litigation, foreclosure, repossession, or collection efforts, forcing those legal actions or collections efforts into a centralized bankruptcy administration. Through bankruptcy, an organization can reduce a secured creditor’s lien down to the value of its collateral. Bankruptcy allows a debtor to reject or avoid economically disadvantageous contracts or leases and avoid a deficiency judgment that would otherwise result when a sale of collateral fails to satisfy the full amount of the debt that is owed. Assets can be sold free and clear of existing liens and interests, making those assets more attractive to third parties. Bankruptcy can be a vehicle for finding strategic partners and creating an unencumbered clean slate moving forward. And it can be a process for restarting or implementing the hospital’s new operational improvement and strategic plans.

Bankruptcy is by no means a remedy for all financial problems; however, it can provide a hospital with the opportunity to correct a struggling course and address accumulated liabilities. There are associated costs to pursuing a bankruptcy case, and certain types of bankruptcy or chapters are more expensive than others. Transparency before a bankruptcy court is essential to obtaining a positive outcome. Bankruptcy cases are rarely quick proceedings; some last several years, but most are completed in one to two years.

Beyond the direct costs and time involved with a bankruptcy filing, there are also reputational implications. A hospital that is in bankruptcy or that has recently emerged from bankruptcy may be viewed with skepticism by vendors from which the hospital seeks credit for trade payables, a routine occurrence for most organizations. Even the public may be skeptical, and local businesses may be adversely impacted. However, many companies have overcome this skepticism—General Motors and Marvel Entertainment are just two high-profile examples. Local businesses will benefit more over time from a viable hospital continuing to serve the community and operate as a large, quality employer while continuing to purchase goods and services going forward. In the end, each hospital should determine whether the costs, scrutiny, time, and reputational concerns outweigh the necessity and benefits of a bankruptcy. For some rural health systems, a bankruptcy filing may be the best option available to chart a viable path forward for the hospital—or the least objectionable option to avoid a hospital closure.

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## Chapter 7 versus Chapter 11

Determining whether a hospital should seek the protections of the Bankruptcy Code is just the beginning. The financial goals of the hospital, as well as the nature of its financial difficulties, will dictate the type of bankruptcy that may be most advantageous. Bankruptcy takes two primary forms: liquidation or reorganization. Liquidation is available to any business under Chapter 7 of the Bankruptcy Code.<sup>4</sup> In Chapter 7, the hospital would stop operating, and a court-appointed trustee would liquidate the assets of the debtor and pay the proceeds to creditors.

Chapter 11 is the prototypical business reorganization. There are no debt limits for Chapter 11.<sup>5</sup> Some Chapter 11s include the liquidation of unwanted assets, often in sales intended to strip liens and interests that would follow the assets if the sale were held outside of bankruptcy. Chapter 11 can also assist with the process of terminating a defined benefit pension plan that the hospital can no longer afford.<sup>6</sup> The goal of Chapter 11 is to have the Court approve a plan of reorganization, which then becomes a contract between the hospital and all its creditors. When the plan is confirmed, the bankruptcy is over, and the plan provides how creditors will be paid over time.

## The Chapter 11 Process

Chapter 11 is a more common process for healthcare organizations to utilize because most of them wish to continue to operate and provide services. The process begins with filing the bankruptcy petition. Once the petition is filed, the debtor becomes a “debtor in possession.” Instead of the Court appointing a trustee as in other types of bankruptcy, in Chapter 11, the hospital continues to manage itself. This is how many companies continue to operate their businesses as usual, despite filing for bankruptcy.

In addition to keeping its business operational, the debtor in possession has additional duties. Those duties include accounting for property, examining and objecting to the claims of creditors, and filing monthly operating reports as required by the Court and the bankruptcy administrator or U.S. trustee.<sup>7</sup> Managing these requirements is difficult. Debtors need to have a good handle on the financial details of their businesses. For this reason, it is often recommended that debtors employ accountants or financial advisors to navigate the process.

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- 4 There are other types of bankruptcy not addressed by this article. Chapter 9 is for municipalities and counties, and many rural hospitals are owned by counties. In some states, rural hospitals are owned by hospital districts. Whether a hospital is eligible for Chapter 9 is a question of state law. Chapter 12 is for family fishermen and farmers. Chapter 13 is for reorganizing the debts of individuals and sole proprietorships. Chapter 15 is for cross-border debtors.
  - 5 A special type of Chapter 11 bankruptcy—the Subchapter V Chapter 11—provides a streamlined, faster, cheaper reorganization for a “small business” if the business has debts below a certain limit.
  - 6 An underfunded pension plan, including a frozen plan, can be terminated if the hospital can prove to the bankruptcy court that the hospital cannot remain in business unless the plan is terminated. In such cases, the Pension Benefit Guaranty Corporation will take over the pension plan. See 29 U.S.C. § 1341.
  - 7 Bankruptcy administrators exist in North Carolina and Alabama. U.S. trustees are in all other states. They serve the same administrative functions.

## Typical Financial Problems Addressed by Chapter 11

The following chart lists common financial problems and corresponding solutions offered by a Chapter 11 bankruptcy.

Problem	Solution
Cash flow needs improvement	<ul style="list-style-type: none"> <li>• Enhance revenue cycle and collection efforts</li> <li>• Operational performance improvement</li> <li>• Restructure payments to secured creditors</li> <li>• Discharge debt owed to unsecured creditors</li> </ul>
Demand is down/market conditions are poor	<ul style="list-style-type: none"> <li>• Discharge debt owed to unsecured creditors</li> <li>• Restructure payments to secured creditors</li> <li>• Write down loans to value of collateral</li> </ul>
Need financing	<ul style="list-style-type: none"> <li>• Obtain post-petition financing</li> <li>• Use cash collateral for post-petition expenses</li> </ul>
Lawsuits are expensive and distracting; secured lender started foreclosure	<ul style="list-style-type: none"> <li>• Automatic stay gives a breathing spell</li> <li>• Remove lawsuits to bankruptcy court</li> </ul>
Burdensome/unwanted contracts or leases	<ul style="list-style-type: none"> <li>• Assume or reject executory contracts and leases</li> <li>• Assume and assign below-market contracts</li> </ul>

## The Plan of Reorganization and the Disclosure Statement

The Bankruptcy Code gives the debtor a 120-day period during which it has the exclusive right to file a plan of reorganization, and that period is often extended. According to the Bankruptcy Code, the plan must designate classes of claims and interests for treatment. Typically, claims are divided into classes based on the type of debt owed, such as taxes (federal, state, and local), secured debt, and unsecured debt. Along with the plan, the debtor must file a disclosure statement, which explains the plan and gives the creditors

and the bankruptcy court an outline of the financial affairs of the debtor and the proposed treatment of creditors. Budgets, projections, and liquidation analyses are typically attached to disclosure statements.

The Bankruptcy Code provides 16 requirements for confirming a plan of reorganization. Among the most important requirements, the plan must:

1. **Be feasible:** For a plan to be feasible, the Court must find that it is not going to require the debtor to liquidate the business (unless the plan specifically proposes a liquidation of assets) or be followed by the need for further financial reorganization.
2. **Be filed in good faith:** The good faith requirement is typically interpreted to require that a plan be proposed with honesty, good intentions, and some basis for expecting that a reorganization or liquidation can be accomplished.
3. **Meet the “best interests of creditors” test:** The best interest of creditors test requires that creditors in a Chapter 11 case receive at least as much under the plan as those creditors would receive in a Chapter 7 liquidation.
4. **Meet the absolute priority rule:** This rule requires that the plan be “fair and equitable” to creditors. Under the absolute priority rule, a class of creditors that votes to reject the plan must receive payment in full or no class of creditors of a lower priority may receive any payment at all.

Once the plan is confirmed, the debtor is required to make the payments outlined in the plan. The confirmed plan is a binding contract between the debtor and its creditors, creating new contractual rights, which replace or supersede pre-bankruptcy contracts and debts. Confirmation of a plan discharges the debtor from any debt that arose before the date of confirmation.

Bankruptcy can be a vehicle for finding strategic partners and creating an unencumbered clean slate moving forward. And it can be a process for restarting or implementing the hospital's new operational improvement and strategic plans.

## Key Board Takeaways

- Board members and officers need to educate themselves about the benefits and burdens of bankruptcy.
- Bankruptcy is not necessarily a liquidation; it can facilitate a fresh start.
- Among other things, bankruptcy offers 1) a breathing spell, 2) a chance to improve cash flow, and 3) a chance to permanently restructure debt.
- Good management alone may not save a distressed hospital.
- Bankruptcy may allow a distressed hospital to shed enough debt to be attractive to a partner or a buyer.

## Conclusion

In most situations, determining whether a hospital would be best served by filing a Chapter 11 bankruptcy is complicated and requires the analysis of many factors. Legal counsel, consultants, and accountants can guide the hospital through the process. Knowing the options can make the difference between survival and closure.

*TGI thanks Tom Waldrep, Jennifer B. Lyday, and Jim Lanik, Partners, Waldrep Wall Babcock & Bailey PLLC, for contributing this article. They can be reached at [twaldrep@waldrepwall.com](mailto:twaldrep@waldrepwall.com), [jlyday@waldrepwall.com](mailto:jlyday@waldrepwall.com), and [janik@waldrepwall.com](mailto:janik@waldrepwall.com).*

