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HOW BANKRUPTCY CAN CHANGE THE BALANCE OF POWER FOR CALIFORNIA HEALTH CARE ENTITIES

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The new federal administration has announced significant tariffs, obstacles to immigration, and has proposed a budget almost certain to impose substantial cuts to the Medicare and Medicaid programs. These developments are sure to worsen the already near constant state of financial distress that California's hospital system faces. As financial pressures mount, hospital operators will be looking for ways to restructure their debts or sell their assets to operators with greater financial resources. In either event, dealing with federal and state regulators—entities with tremendous power to prevent or interfere with transactions— will be essential, but need not be unavoidable. Using the bankruptcy courts as a tool, hospitals can shift the balance of power and secure more favorable processes and outcomes. These include obtaining judicial review more quickly, transferring provider agreements without successor liability, combating arbitrary suspension of payments for alleged fraud, dealing with California Attorney General ("CAG") review of proposed sales of nonprofit hospitals, and resolving Medicare or Medi-Cal [1] fee-for-service offsets meant to redress prior overpayments. In short, bankruptcy proceedings present a powerful tool for hospital operators given the many challenges that likely lay ahead.

I. Background

Financial distress is no stranger to California healthcare providers. California hospitals and skilled nursing facilities have long struggled with low reimbursement rates, high labor costs, significant numbers of uninsured patients resulting in high levels of charity or uncompensated care, and disproportionate costs for capital expenditures, such as those to address seismic issues. Healthcare providers cannot easily pass on these increased costs because, in large part, Medicare and Medi-Cal, which already don't pay enough to cover the cost of caring for their patients, [2] also don't provide for reimbursements to quickly adjust to increased operating costs. These financial stressors are likely be exacerbated in 2025 thanks to a deepening shortage of nurses, increased labor costs caused by mandatory staffing requirements, tariff-induced increases in the cost of goods, an increased effort by federal and state regulators to identify fraud, waste, and abuse in the Medicare and Medi-Cal programs,and, not insignificantly, a proposed reduction of over $800 billion in Medicaid reimbursements, which will necessarily result in substantial reductions in Medi-Cal reimbursements.

Medicare and Medi-Cal are the proverbial "800-pound gorilla" in California's healthcare system. Collectively, these programs pay for 38.2% of hospital stays [3] and 81% of skilled nursing facility stays in California, respectively. [4] Also relevant to note is the disproportionate impact on nonprofit entities since 59% of California's hospitals [5] and 12% of its skilled nursing facilities are nonprofits. [6]

This is noteworthy for bankruptcy purposes because the CAG has significant authority over nonprofit transfers, including the power to approve the transfer or impose significant operational and financial conditions on the acquiring entity. [7] Thus, dealing with issues related to Medicare and Medi-Cal for all healthcare providers, or CAG oversight and approval for nonprofit healthcare providers, can be determinative in the sale of a healthcare entity.

II. Using Bankrupcy to Change the Balance of Power

A. Bankruptcy Courts Do Not Have To Wait For Healthcare Providers To Exhaust Administrative Remedies Before Reviewing A Medicare Dispute

Outside of bankruptcy, the rules are clear: healthcare providers with a pending Medicare dispute cannot obtainreview by a federal court unless and until the provider exhausts Medicare's administrative remedies process. [8] Exhausting the administrative remedy process requires completion of four levels of appeal before a provider can seek federal court review. Importantly, the Medicare program can impose offsets on a provider's fee for service reimbursements to recover on alleged overpayments even before the appellate process concludes.

This forces the provider to live with reduced reimbursement—or maybe no reimbursement at all—before it has even had an opportunity to fully litigate its appeal.

Thankfully, providers can find a useful remedy in the bankruptcy courts. This is because the Ninth Circuit, as well as other circuits do not require, bankruptcy courts to wait for the provider to exhaust its administrative remedies before stepping in to take action. This is because of the unique nature of bankruptcy proceedings [9] and other considerations. [10] This effectively gives providers a way of circumventing the otherwise mandatory and time consuming administrative process.

B. Bankruptcy Courts Can Authorize The Sale of Medicare and Medi-Cal Provider Agreements Without Successor Liability

Most buyers of nonprofit hospitals will want to take the Medicare and Medi-Cal Provider Agreements as part of the assets they purchase. This is desirable for buyers because obtaining the seller's provider agreement avoids a gap in payments from Medicare and Medi-Cal for providing care to the programs' beneficiaries.

This is also preferable to the alternative, where the buyer seeks to obtain its own new Medicare or Medi-Cal provider agreement. Under this arrangement, the government requires an inspection prior to issuance of that new provider agreement, a process that can take months to fulfill, oftentimes without reimbursement despite obligations to provide treatment.

At the same time, assuming a seller's Medicare or Medi-Cal provider agreement could also saddle a buyer with significant unknown liability. For example, there may be years of unaudited cost reports. Outside of bankruptcy, if a cost report is audited years later and an overpayment is discovered, the buyer will be liable for that overpayment and will have to pay the overpayment amount to the relevant program. To protect themselves, buyers will frequently adjust the amount they are willing to pay for a facility, or will escrow significant amounts from the purchase price, to be paid over to the seller only after the cost reports are finalized and no overpayments are discovered.

This is another area where the application of the Bankruptcy Code can alter the balance of power with federal or state regulators because the transfer of a hospital in bankruptcy can allow the buyer to obtain the seller's provider agreements without also accepting successor liability. This is because the sale proceeds pursuant to section 363 of the Bankruptcy Code, which allows the sale to go forward without successor liability.

That said, one remaining issue that must be resolved is whether the acquired provider agreement is a license, which can be sold pursuant to section 363, or an executory contract, which must be sold pursuant to section 365 of the Bankruptcy Code. Unlike section 363, section 365 requires that the contract be sold "cum onere," or with its obligations, meaning the buyer of an executory contract must take on the seller's obligations. In the context of the Medicare and Medi-Cal provider agreements, this effectively means that the buyer assumes successor liability.

Outside of bankruptcy, the federal and state governments argue with virtually complete success that the Medicare and Medi-Cal provider agreements are not contracts. Appellate courts have uniformly agreed. [11] In bankruptcy, however, the federal and state governments argue that Medicare and Medi-Cal provider agreements are executory contracts. This argument is hard to fathom, because the Bankruptcy Code adopts non-bankruptcy law on what is a contract and nothing about the filing of a bankruptcy case should (or could) convert a document that is not a contract outside of bankruptcy into a contract inside of bankruptcy. Nonetheless, most bankruptcy courts to consider the issue have treated Medicare and Medi-Cal provider agreements as executory contracts, most frequently because the providers do not challenge that assertion, and because bankruptcy practitioners and bankruptcy judges are simply unaware of the non-bankruptcy treatment of these provider agreements.

The Verity bankruptcy is instructive here.

In the Verity bankruptcy, the debtor sought to sell its Medi-Cal provider agreements pursuant to section 363 of the Bankruptcy Code as a license. The California Department of Health Care Services [12] ("DHCS"), however, argued that the provider agreements could only be transferred as an executory contract pursuant to section 365 of the Bankruptcy Code. DHCS supported this argument by reasoning as follows.

First, DHCS argued that the provider agreement was a contract because it imposed mutual obligations on both parties; namely, requiring the provider to render medical services to Medi-Cal beneficiaries while DHCS had to pay for those services. In response, the debtor countered that the Medi-Cal provider agreement had numerous provisions establishing what the provider had to do, whereas the state's obligations were established by statute or regulation. The debtor argued this was relevant because well-established contract law principles held that a document where one party's obligations were all imposed by law did not create a contract. [13]

Second, DHCS argued that the Medi-Cal provider agreement should be treated as an executory contract because that is how most bankruptcy courts have treated Medicare provider agreements. In effect, DHCS argued that Medi-Cal provider agreements were analogous to those of Medicare, and therefore should similarly be treated as executory contracts.

In response, the debtor argued that the vast majority of those cases involved a debtor that had conceded the argument, thereby agreeing that the Medicare provider agreement was an executory contract. In other words, these conclusions were the result of a party's stipulation, not a legal finding by a court. The Verity debtor also observed that controlling Ninth Circuit precedent held that Medicare provider agreements are not a contract, [14] and that Medi-Cal provider agreements were not contracts, either. [15] The bankruptcy court agreed with the debtor and held that the Medi-Cal provider agreement was not a contract and, therefore, could be sold without successor liability pursuant to section 363. [16]

Remarkably, DHCS immediately entered into a settlement with the debtor, agreeing to essentially transfer the Medi-Cal provider agreement without successor liability in exchange for the debtor agreeing to jointly ask the bankruptcy court to vacate the opinion. The federal Centers for Medicare and Medicaid Services ("CMS") also quickly entered into a settlement allowing the transfer of the Medicare provider agreement without successor liability. Although this opinion was vacated, it can still be cited for the value of its reasoning.

C. The Bankruptcy Court Can Halt A Medicare Or Medi-Cal Suspension Of Payments, Even Where There Are Allegations Of Fraud

Rooting out healthcare fraud has long been a priority of the federal and state governments.

In an effort to maximize the value of the remedies available to their enforcement agencies, federal and state statutes and regulations permit the fiscal intermediaries to suspend Medicare and Medicaid payments on the basis of "credible allegations of fraud" with virtually no remedies to halt the suspension being available to the provider. However, bankruptcy proceedings can alter the balance of power by providing a forum to dispute the suspension, and, in many cases, stopping the suspension and giving the provider time to negotiate a settlement.

For example, in August 2023, DHCS notified Borrego Community Health Foundation ("Borrego") that it intended to suspend 100% of Borrego's Medi-Cal payments in 30 days. [17] This threatened suspension created an existential threat to Borrego, as Medi-Cal represented over 44% of its income. To prevent being compelled to cease operations, Borrego commenced a Chapter 11 bankruptcy case and an adversary proceeding seeking declaratory and injunctive relief, or, alternatively, a writ of mandate under section 1085 of the California Code of Civil Procedure. Borrego asserted three grounds for the application of the automatic stay:

(1) The suspension violated the automatic stay under section 362(a)(1) of the Bankruptcy Code because the debtors possessed a valid right to payment of the prepetition suspended payments;

(2) The suspension violated section 362(a)(3) of the Bankruptcy Code, as an impermissible effort to obtain possession of or exercise control over property of the estate; and

(3) The suspension was an act to collect a pre-petition claim, in violation of sections 362(a)(1) or (6) of the Bankruptcy Code.

In response, DHCS argued that the suspension was not subject to the automatic stay because it was a police or regulatory act, exempt under section 362(b)(4) of the Bankruptcy Code. The Bankruptcy Court held for Borrego, finding that the suspension would violate the automatic stay as there was no evidence on ongoing fraud, rendering the proposed suspension merely an act to ensure the Medi-Cal program was paid. [18]

D. The Bankruptcy Court Can Cut Off Conditions Imposed By A State Attorney General On The Sale Of A Nonprofit Facility

The CAG has immense powers over the sale of nonprofit hospitals. This includes the power to approve or disapprove of the sale, or the imposition of mandatory conditions of approval on the buyer and seller before the transaction can close. For the last category, these conditions are frequently quite onerous and can relate to both financial and operational aspects of the hospital's business. For example, in the bankruptcy case of Verity Health System of California, the CAG sought to impose numerous conditions on Verity's sale of four hospitals to a for-profit entity. These included conditions on operations, finances, corporate governance, the level of charity care provided by the facilities, the number of emergency treatment stations, the kind of services provided by the hospitals, capital expenditure requirements, and prohibiting the buyer from cancelling certain contracts for a specified number of years. [19] At a minimum, these conditions made future operations on a sound financial basis by any operator problematic; at worst, it made the sale of a hospital to a financially sound operator impossible, inevitably leading to the closure of the hospital.

The Bankruptcy Code has three specific provisions which apply to the sale of nonprofit hospitals:

(1) Section 363(d), permitting a trustee to use, sell, or lease property of a nonprofit in accordance with non-bankruptcy law applicable to the transfer of property by a like-kind debtor or trust;

(2) Section 541(f), providing that property held by a nonprofit debtor may be transferred to an entity that is not such a corporation, "but only under the same conditions as would apply if the debtor had not filed a case under [the Bankruptcy Code]"; and

(3) Section 1129(a)(16), which requires all transfers of property under the plan to be made in accordance with any applicable provisions of non-bankruptcy law that govern the transfer of property by a corporation or trust that is not a for-profit entity. These provisions were added to the Bankruptcy Code in 2005 without significant discussion or legislative history, and there has been little litigation, and hence few reported decisions, as to their exact meaning.

The meaning of these three statutes came to a head in the Verity Health System proceedings during Verity Health's efforts to sell its six acute care hospitals in bankruptcy.

The bankruptcy court had to determine whether these rules required adherence to the applicable state law as to the process of obtaining CAG approval as the debtor argued or, as the CAG argued, required the bankruptcy court to treat the CAG's powers as unaffected by the bankruptcy proceeding. After a sale was approved through an auction overseen by the bankruptcy court, the debtor submitted the voluminous application paperwork required under state law. These records revealed that the buyer agreed to accept certain conditions if imposed by the CAG but only so long as they were not more onerous than the terms provided in the original asset purchase agreement. The application also disclosed that the asset purchase agreement permitted the buyer to walk away from the transaction if the CAG did not approve the sale. Ultimately, the CAG approved the sale, but sought to impose numerous conditions on the buyer which exceeded the conditions the buyer was willing to accept. Citing federal preemption of state law, the bankruptcy court concluded section 363 permitted it to approve the sale and cut off these conditions because they were based on the historical operations of the seller and, therefore, represented the imposition of successor liability. [20]

The option to transfer a nonprofit hospital without forcing a buyer to accept onerous operational or financial conditions imposed by the CAG is a significant development that can enure to the benefit of similarly situated debtors.

III. Conclusion

Outside of bankruptcy, financially distressed healthcare providers have very little leverage in disputes with the Medicare and Medi-Cal programs and the regulatory agencies that administer those programs. Additionally, if those providers are nonprofits, the CAG can impose conditions which significantly affect any efforts to transfer financially distressed facilities. While certainly not a decision to be taken lightly, commencing a bankruptcy case can significantly alter the balance between the provider and state and federal regulators, in that it can allow for immediate access to a federal court to resolve disputes, imposes an automatic stay that can limit the regulators powers to impose suspensions, allow for the transfer of Medicare and Medi-Cal provider agreements and facilities generally without successor liability for the buyer, and, in the case of nonprofits, can restrict the CAG's ability to impose conditions on the sale of the facilities.

Endnotes

[1] “Medi-Cal” is California’s Medicaid program.

[2] See American Hospital Association, The Cost of Caring: Challenges Facing America’s Hospitals in 2025 (April 2025), available at https://www.aha.org/costsofcaring#:~:text=Medicare%20and%20Medicaid%20Reimbursements%20Are,annually%20between%202019%20and%202023 (last viewed on May 31, 2025).

[3] See Definitive Healthcare, Hospital payor mix by state (Dec. 9, 2024), available at https://www.definitivehc.com/resources/healthcare-insights/hospital-payor-mix-state (last viewed on May 31, 2025).

[4] See California Association of Health Facilities, Facts and Statistics, available at https://www.cahf.org/About/Consumer-Help/Facts-and-Statistics#:~:text=California%20has%206.3%20million%20Medicare,For%20more%20information%20visit%20Medicare (last viewed on May 31, 2025).

[5] See Yang, J., Statista, Number of hospitals in California in 2022, by ownership type (June 20, 2024), available at https://www.statista.com/statistics/202799/number-of-hospitals-in-california-by-ownership-type/ (last viewed on May 31, 2025).

[6] See California Association of Health Facilities, Facts and Statistics, available at https://www.cahf.org/About/Consumer-Help/Facts-and-Statistics#:~:text=California%20has%206.3%20million%20Medicare,For%20more%20information%20visit%20Medicare (last viewed on May 31, 2025).

[7] See State of California Department of Justice, Nonprofit Health Facility Transaction Notices, available at https://oag.ca.gov/charities/nonprofithosp#:~:text=California%20law%20requires%20the%20Attorney,operated%20by%20a%20nonprofit%20corporation.https://oag.ca.gov/charities/nonprofithosp#:~:text=California%20law%20requires%20the%20Attorney,operated%20by%20a%20nonprofit%20corporation (last visited on May 31, 2025).

[8] 42 U.S.C. §405(h) provides that “The findings and decision of the [Secretary of HHS] after a hearing shall be binding upon all individuals who were parties to such hearing. No findings of fact or decisions of the [Secretary] shall be reviewed by any person, tribunal, or governmental agency except as herein provided. No action against the United States, the [Secretary] or any officer or employee thereof shall be brought under section 1331 or 1346 of Title 28 to recover on any claim arising under this subchapter.” 42 U.S.C. §405(h) applies to the Medicare program via operation of 42 U.S.C. §1395ii.

[9] See Sullivan v. Town & Country Home Nursing Servs., Inc. (In re Town & Country Home Nursing Servs., Inc.), 963 F.2d 1146 (9th Cir. 1991); see also Do Sung Uhm v. Humana, Inc., 620 F.3d 1134 (9th Cir. 2010) (“But upon closer reading, Kaiser and In re Town & Country can be reconciled. In re Town & Country’s reasoning relies almost exclusively on the special status of § 1334’s “broad jurisdictional grant over all matters conceivably having an effect on the bankruptcy estate. . . .” Thus, its reading of 42 U.S.C. § 405(h) can reasonably be understood to apply only to actions brought under § 1334, while not bearing on the relationship between § 405(h) and other jurisdictional provisions such as § 1332.” (citations omitted)).

[10] See Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.), 973 F.2d 1065 (3d Cir. 1992) (“Thus we agree with the Ninth Circuit that ‘where there is an independent basis for bankruptcy court jurisdiction, exhaustion of administrative remedies pursuant to other jurisdictional statutes is not required.’”); In re Benjamin, 932 F.3d 293 (5th Cir. 2019) (“With respect to the majority of our sister circuits, we reject the non-textual approach exemplified by the Eleventh Circuit and join the Ninth Circuit in applying the third sentence’s plain meaning—a meaning that, everyone agrees, does not bar §1334 jurisdiction.”). But see In re Bayou Shores SNF, 828 F.3d 1297 (11th Cir. 2016) (“Because we are persuaded that the 1984 amendments to §405(h) were a codification and not a substantive change, we ... hold that §405(h) bars §1334 [bankruptcy court] jurisdiction over claims that ‘arise under [the Medicare Act].’”).

[11] See, e.g., Memorial Hospital v. Heckler, 706 F.2d 1130,1136-37 (11th Cir. 1983) (holding that "[u]pon joining the Medicare program, however, the hospitals received a statutory entitlement, not a contractual right."), cert. denied 465 U.S. 1023 (1984); Harper-Grace Hospitals v. Schweiker, 708 F.2d 199, 201 (6th Cir. 1983) ("[the health care provider] has not shown that the Medicare program established a contractual relationship between the hospital and federal government).

[12] DHCS is California’s single state entity responsible for administering and overseeing the Medi-Cal program.

[13] In re Gardens Regional Hospital and Medical Center, Inc., 569 B.R. 788 (2017) (citing Auerbach v. Great W. Bank, 74 Cal. App. 4th 1172, 1185, 88 Cal.Rptr.2d 718, 727 (Cal. Ct. App. 1999)).

[14] In re PAMC, Ltd. v. Sebelius, 747 F.3d 1214, 1221 (9th Cir. 2014) (Noting that hospitals receive a “statutory entitlement” to bill Medicare, not a contractual right, upon joining the Medicare program.).

[15] Guzman V. Shewry, 552 F.3d 941, 954 (9th Cir. 2009).
[16] In re Verity Health Sys. Of California, Inc., 606 B.R. 843 (Bankr. C.D. Cal. 2019).
[17] See Borrego Community Health Foundation v. Dept. of Health Care Services, Adv. Proc. No. 22-90056-LT, Findings Of Fact And Conclusions Of Law Re: Emergency Motion To (I) Enforce The Automatic Stay Or (II) Alternatively For Temporary Restraining Order, Docket No. 65, In re Borrego Community Health Foundation, Case No. 22-02384-LT11 (Bankr. S.D. Cal. Oct. 26, 2024) ("Borrego Findings").
[18] See Borrego Findings, supra. See also In re Medicar Ambulance Co., Inc., 166 B.R. 918 (Bankr. N.D. Cal. 1994) (Fiscal intermediary ordered to discontinue its suspension of Medicare payments and to turn over to the debtor all amounts placed in the suspense account.).
[19] See State of California Department of Justice, Attorney General Becerra: Patient Protections Paramount in Sale of Verity Health Facilities (Sept. 26, 2019), available at https://oag.ca.gov/news/press-releases/attorney-general-becerra-patient-protections-paramount-sale-verity-health (last viewed on May 31, 2025).
[20] See Memorandum Of Decision Granting Debtor's Emergency Motion To Enforce The Sale Order, In re Verity Health Sys. Of California, Inc., Case No. 2:18-bk-20151-ER, United States Bankruptcy Court for the Central District of California, Los Angeles Division [Docket No. 3446], entered Oct. 23, 2019. This was only one of several similar orders entered in the Verity bankruptcy case. See Order Granting Debtors' Emergency Motion For The Entry Of An Order: (I) Enforcing Order Authorizing The Sale To Prime Healthcare Services, Inc.; (II) Finding That The Sale Is Free And Clear Of Additional Conditions; (III) Finding That The Attorney General Abused His Discretion In Imposing Additional Conditions On The St. Francis Medical Center Sale; And (IV) Granting Related Relief [Docket No. 5482], entered Aug. 12, 2020 (overruling the Attorney General's conditions on the sale of St. Francis Medical Center); and Memorandum Of Decision Overruling Objections Of The California Attorney General To The Debtors' Sale Motion [Docket No. 1146], entered Dec. 26, 2018 (overruling the Attorney General's conditions on the Sale of two hospitals to Santa Clara County).

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