

An Update on Chapter 9 Hospital Bankruptcies



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The authors are members of Dentons' Restructuring, Insolvency and Bankruptcy practices. With more than 25 years' experience representing health care industry stakeholders in complex transactions and high-stakes disputes, Dentons' dedicated, multidisciplinary Distressed Health Care group brings unparalleled experience to the handling of matters involving financially distressed clients and transactions, in and outside of formal bankruptcy proceedings. Our client representation includes multistate health systems, academic medical centers and independent standalone hospitals, for-profit and nonprofit, in the U.S. and abroad, as well as leading health insurers, pharmaceutical and medical device companies, lenders and investors, and governmental and NGO participants.

On May 23, 2023, the San Benito Health Care District, d/b/a Hazel Hawkins Memorial Hospital (the "District"), filed for chapter 9 bankruptcy, citing limited access to working capital, labor expenses (constituting 70% of the hospital's annual expenses), and cash flow and revenue issues as the main reasons precipitating the filing. These issues are not limited to this debtor. Rather, many public health care organizations are facing similar challenges and may be able to take advantage of chapter 9's provisions, which can help ensure they are providing quality care to their communities and achieving financial stability. This article provides an overview of the relatively rare use of chapter 9 and an update on the District's bankruptcy case.

Chapter 9 Basics

Chapter 9 is a special chapter of the Bankruptcy Code that allows municipalities facing insolvency to seek protection from their creditors. In a chapter 9 case, a municipality continues to operate while developing a plan to reorganize its debts. Chapter 9 debtors can continue operating with little to no disruption, including making payroll, caring for patients and running facilities.

Only a municipality may file for relief under chapter 9; however, the Bankruptcy Code's definition of a "municipality" is very broad, defining it as a "political subdivision or public agency or instrumentality of a State." [1] As such, counties, townships, school districts, cities, and other public entities such as public hospitals may file for relief under chapter 9.

In order to qualify as a chapter 9 debtor, a municipality must also meet the following requirements under Bankruptcy Code § 109(c):

- The municipality must be specifically authorized to be a debtor under state law or by an officer or organization empowered by a state law to authorize a filing;
- the municipality must be insolvent pursuant to 11 U.S.C. § 101(32)(C);
- the municipality must demonstrate its plan to reorganize its debts; and
- the municipality must have negotiated in good faith with its creditors before filing by:
 - entering into an agreement with a majority of its creditors;
 - negotiating in good faith with a majority of its creditors, but was unable to reach an agreement;
 - indicating negotiations with its creditors are impracticable; or
 - reasonably believing a creditor may attempt to obtain a preference.

Municipalities will reorganize their debts under chapter 9 by implementing a court-approved plan of adjustment. [2] The standards for approving a plan of adjustment are similar to those in a chapter 11 case, however, there are many differences between the two chapters.

Unlike in chapter 11, chapter 9 debtors cannot be involuntarily forced into bankruptcy, cannot be converted to another chapter, and are not required to provide as many disclosures, such as schedules and statements of financial affairs. [1] A creditor's role in a chapter 9 is more limited than in other cases, as there is no meeting of creditors, and creditors are not allowed to file competing plans. This is very beneficial, as it allows chapter 9 debtors more freedom to operate and reorganize. However, a committee of unsecured creditors may still be appointed, and chapter 9 debtors are still required to file a list of creditors and note whether the claims are contingent, unliquidated, or disputed.

Due to limitations of Congress's power under the 10th Amendment to the U.S. Constitution, a bankruptcy court is restricted in its powers to interfere with the operations of a chapter 9 debtor. [3] Consequently, a bankruptcy court is not as involved in a chapter 9 case. Chapter 9 debtors are not required to obtain court authority to use cash collateral, obtain credit or employ professionals. [2] Section 904 specifically limits a bankruptcy court's powers to interfere with the political and governmental powers and daily operations of a chapter 9 debtor. [3]

Previous Chapter 9 Hospital Cases

It is important to note that chapter 9 filings are relatively infrequent, and that it is even more rare for hospitals to file under chapter 9. Sometimes, a hospital's chapter 9 filing may even be the first a district has seen. Many public hospitals choose more traditional alternatives, such as mergers, partnerships, or financial assistance from governmental or private entities. Others simply close. [4]

Many public hospitals that do file for chapter 9 cases are smaller and involve rural hospitals. [5] But that does not mean that large hospitals with complex operations cannot use chapter 9. For instance, the debtor in the *In re Valley Health System* case filed in the Central District of California had a 113-bed skilled nursing facility and three acute hospitals. Each hospital provided comprehensive health services and 24-hour emergency medical services. [6]

Hazel Hawkins Chapter 9 Filing

One entity that recently took advantage of the benefits of chapter 9 bankruptcy is the District, which is located in Hollister, Calif. The District filed chapter 9 on May 23, 2023, in the Northern District of California, [4] which is pending before Hon. Stephen L. Johnson.

Prior to filing, the District participated in a neutral evaluation process pursuant to Section 53760 of the California Government Code. The neutral evaluation process expired without a resolution of the outstanding issues with interested parties, therefore the District's board of directors adopted a resolution authorizing the District to file under chapter 9. [7] During the neutral evaluation process, the District also negotiated in good faith with creditors, but failed to obtain agreement. [8]

On June 13, 2023, the District filed a motion to reject certain collective bargaining agreements (CBAs). [9] Through the motion, the District seeks to reject certain union agreements and "pursue either a transaction or proceed to restructure its services to continue independent operations (likely) with reduced services." The motion indicates that the District had attempted to negotiate modifications to the CBAs with certain unions pre-petition, but the parties made no material progress. Additionally, the majority of the District's workforce is represented by the unions, which has made it difficult for the District to reduce labor costs without an agreement with each union. This motion will certainly be contested, and only time will tell how it will play out.

The District operates a 25-bed acute care hospital, two skilled-nursing facilities, five rural health clinics, two specialty centers and two laboratories, all operating under a single, consolidated California general acute care hospital license. [10] The District has experienced cash-flow shortages that are mainly due to systemic issues owing to the District's payor mix, size, location and imbalances in labor expenses. [11]

Prior to filing, the District implemented initiatives to stabilize its finances in the short term and began seeking a transaction partner. As of the bankruptcy filing, the District had not identified a transaction partner and had not reached deals with certain principal stakeholders to adjust its debts. [12] According to its interim CEO in her declaration in support of first-day motions, the District intends to use the bankruptcy process to adjust its liabilities to stabilize the District's finances in the long term, and to either pursue a transaction or restructure operations to permit the District to continue independently. [13]

As of the bankruptcy filing, the District owed \$24.15 million on 3.58% bonds due in 2035 and \$11.23 million on 4% bonds issued in 2021. [14] The District also has secured debt in the amount of \$1.85 million owing to the California Health Facilities Financing Authority, and several bridge loans totaling approximately \$3.5 million. The District owes approximately \$18 million to unsecured creditors. [15]

Conclusion

The Hazel Hawkins chapter 9 bankruptcy could serve as a precedent for other public hospitals faced with tight cash and increasing pressures on operations in the coming months. Legal advisors should monitor this as a test case for whether the unique benefits of chapter 9 can allow for a successful reorganization compared to chapter 11.

Editor's Note: Author Samantha Ruben is a member of ABI's Health Care Committee.

[1] See Chapter 9 vs. Chapter 11 Comparison Chart, Practical Law Checklist w-002-1928.

[2] See *United States Courts: Chapter 9 Bankruptcy Basics*.

[3] 11 U.S.C. § 904.

[4] See, e.g., “The Lone Hospital in This Central Valley County Closed” (discussing closure of Madera Community Hospital), Soumya Karlamangla, Apr. 10, 2023, www.nytimes.com/2023/04/10/us/madera-community-hospital-california.html.

[5] See Diane Lourdes Dick, “Public Hospital Bankruptcies and an Evolving Functional Interpretation of the Bankruptcy Code,” *Bankruptcy Law Letter*; see, e.g., *In re Coalinga Reg’l Med. Ctr.*, 608 B.R. 746, 747 (Bankr. E.D. Cal. 2019) (noting debtor was a rural hospital).

[6] *In re Valley Health Sys.*, 381 B.R. 756, 758–59 (Bankr. C.D. Cal. 2008).

[7] See Debtor’s Statement of Qualification under 11 U.S.C. § 109(c), Case No. 23-50544, Docket No. 2.

[8] See *id.*

[9] Case No. 23-50544, Docket No. 44.

[10] See Declaration of Mary Casillas in Support of Emergency First Day Motions, Case No. 23-50544, Docket No. 10.

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] See *id.*