

Healthcare Financing: **10 Key Issues for Borrowers and Lenders in Healthcare** **Lending Transactions**

By

Don Ensing¹ and Bart Walker²

The Healthcare industry, like most other regulated industries, presents numerous challenges associated with lending transactions and financing arrangements between lenders and borrowers. Both lenders and borrowers can benefit from learning about the issues and concepts that are important to the other parties in the transaction. By familiarizing themselves with the fundamentals of the healthcare lending industry, borrowers can discover what general types of requirements lenders typically impose upon borrowers prior to seeking financing. This can assist borrowers and lenders alike to manage expectations and can help prepare borrowers to develop financing proposals and to negotiate the loan documents.

This article focuses on traditional asset-based and cash flow lending to health care facilities and businesses. It does not focus on bond financing, private equity or private debt markets or specific issues related to financing for tax exempt entities.

¹ Don Ensing is a senior associate in the McGuireWoods LLP Financial Services and Banking Department, practicing in the firm's Chicago office. Mr. Ensing concentrates on corporate finance and general corporate law. His experience includes syndicated, secured and unsecured senior debt, second lien loans, mezzanine debt, letter of credit facilities, credit enhancement for bonds, and acquisition financing, involving borrowers in many different fields and collateral of all types. McGuireWoods LLP is the nation's fifth largest health care law firm as ranked by the American Health Lawyers Association.

² Bart Walker is an associate in the McGuireWoods LLP Healthcare Department, practicing in the firm's Charlotte and Chicago offices. Mr. Walker's practice is concentrated in the areas of mergers, acquisitions, sales, private offerings of securities, and related transactions, including debt and private equity financing. His practice includes advising ambulatory surgery centers, specialty hospitals, practices and hospitals on various regulatory and transactional matters. McGuireWoods LLP is the nation's fifth largest health care law firm as ranked by the American Health Lawyers Association.

1. Compliance with Term Sheet or Credit Approval.

The initial concern for the lender and the borrower should be to ensure that the actual transaction documents reflect the contents of the term sheet or the credit approval. The documents should memorialize the terms approved by the credit committee so that the business aspects of the deal are not lost in translation. Failure to do so can result in the lender being under-collateralized, insecure in its collateral or missing key points of negotiation in the lending transaction. For example, if the term sheet specifies joint and several guarantees of the members of a company while the documents reflect a pro rata and limited guaranty, there can be significant credit decision implications for the lender. This process can be equally valuable for borrowers. Borrowers should also confirm that negotiated business points are correctly and completely documented.

2. Diligence.

A lender should ensure that the level of due diligence involved in a healthcare lending transaction is appropriate to the sophistication and risk level of the lending transaction itself. Because due diligence can significantly impact the price and cost of legal services, the lender should make sure that the necessary amount of diligence is conducted to justify the lending risks involved, while remaining mindful of the associated costs. Key points in diligence include UCC, tax and judgment lien searches performed by a service company, assessment of the borrower's outstanding debt, evaluation of real estate issues and access to the lender's collateral and proof of sufficient insurance coverage (both general and professional liability). Lenders should be wary of potential risks to the profitability or survival of the borrower

that could impact its ability to repay the debt obligations. Potential sources of liability include the way in which healthcare companies market their services or products, heavy reliance on one or two referral sources if a health services provider, malpractice or products liability lawsuits or Medicare and Medicaid overpayments. In one recent failed transaction, a lender discovered that the borrower was subject to several significant pending qui tam suits and in another the borrower was subject to multiple medical malpractice claims, for which the company had no reserves and was inadequately insured.

3. Collateral Issues.

A number of issues can arise when dealing with healthcare-specific collateral such as Medicare and Medicaid accounts receivable, medical and office equipment, real estate and other assets. Depending upon the type of loan, whether equipment, working capital or for future growth or investment, the lender may have collateral that includes essentially all of the borrower's assets or very specific assets. Further, depending upon the size and maturity of the borrower, the lender may or may not require personal or corporate guarantees or other security. Oftentimes in healthcare lending -especially with group practices, surgery centers and hospitals -one particular piece of expensive medical equipment could be the main source of collateral security for the lender. This is especially true if the lender's main line of business is lending for equipment costs or start-up operations. Such equipment could be imaging equipment, operating or surgical room fixtures or laboratory equipment. Where a single piece of machinery or equipment is the sole or major source of collateral, lender should ensure that such equipment is properly insured against damage and replacement. Further, lenders should ensure that the appropriate UCC filings or mortgages are completed in order to perfect the lender's security interest. In the event of default under the loan, a lender will usually require a right of entry and the right to show or sell a piece of equipment on the premises where the collateral equipment is located. This will also need to be included in an agreement with the borrower's landlord in order to protect the lender's rights. A special case exists as to Medicare and Medicaid account receivables as collateral, which we will deal with next.

4. Accounts Receivable.

Where a particular borrower includes Medicare or Medicaid accounts receivable as part of the collateral on the loan, special steps must be taken in order to perfect a lender's security interest in those accounts receivable. In particular, federal regulations³ do not allow Medicare or Medicaid accounts receivable to be held in an account controlled by a third party other than a licensed Medicare or Medicaid entity. The revised Article 9 of the UCC in 2001, however, included healthcare insurance receivables as a subset of "Accounts."⁴ A security interest can be created in healthcare insurance receivables, including Medicare or Medicaid receivables, but it cannot be "perfected" unless the secured party has control over the Deposit Account in question. Because "control" over a Deposit Account is the touchstone for perfection of a security interest under the UCC,⁵ a security interest can be taken, but not technically perfected, in such Medicare or Medicaid Deposit Accounts. The healthcare lending industry has, however, evolved a method to protect a lender's security interest in such Deposit Accounts.

Lenders commonly require implementation of a "double lockbox" arrangement, at one or more banks. A restricted deposit agreement establishes in the borrower's name a specific borrower-controlled account which serves as a holding account for Medicare receivables. Once the cash from Government Receivables (i.e. -Medicare or Medicaid Accounts Receivable) is deposited in the restricted account over which the borrower has sole control, the cash is swept, usually at the end of each day, into a separate account in the lender's name and under lender's control. The result is the deposit of Government Receivables proceeds in an account over which the lender has a perfected security interest. By having control over the second account into which the cash from Medicare receivables is swept, the lender has a perfected security interest in the collateral. Note that the security interest here is not held directly in the Government Receivables, but rather is in the form of the Deposit Account into which the cash proceeds of Government Receivables is swept.

³ See 42 U.S.C. § 1395g(c), 42 C.F.R. § 424.71, 42 U.S.C. § 1395u(b)(6) and 42 C.F.R. § 424.80.

⁴ See Uniform Commercial Code § 9-102(2) cmt. 5 (2001).

⁵ Uniform Commercial Code § 9-102(a)(46).

An additional step that lenders can take to protect their interests in accounts receivable of all kinds is to ensure that the loan agreement does not allow the borrower to settle or dispose of claims without written notice or prior approval of the lender. This can become problematic in situations where borrowers such as group practices, hospitals or surgery centers in the ordinary course of business settle or negotiate for lower payment of patient bills or do not receive full reimbursement for Medicare or Medicaid. Lenders typically remain flexible and allow some negotiation or settlement of accounts without prior approval, but limits can be set on the borrowers ability to do this.

5. Insurance.

In addition to insuring expensive medical equipment that is the source of collateral for a lender, healthcare lending often requires that the borrowers have adequate professional liability insurance and interruption of business insurance in order to safeguard against losses to collateral such as accounts receivable. Lenders typically request to be named as a loss payee or primary beneficiary on the policy as well. Borrowers should be mindful that the loan agreement could include provisions which would make it difficult for the borrower to rebuild or replace damaged equipment in the event of a loss and should negotiate accordingly. Exceptions can often be made for cases where the borrower would like to continue its operations despite insurance claims or losses.

6. Operating Agreement or Membership Restrictions.

As a general rule, a lender should verify that the operating agreement or other entity operating document does not contain any limitations on the ability of the company to borrow funds from any source or in whatever amount. Often, companies have limits on the amount that the company or board of directors or managers can borrow without obtaining the prior approval of its members or partners. The lender must therefore ensure that the requisite approvals and consents have been obtained according to the entity's operating document. Further, such organizational documents could place restrictions on member guarantees or the ability of the company to grant

collateral security interests in its assets. Each of these types of provisions could potentially impact the lender and the ability of the borrower to close the transaction.

Lenders often condition financing of start-up operations upon evidence of a minimum amount of equity contribution to the enterprise from other investors or principals of the company. If such a condition is in place, the lender should verify that all such sums have been received by the company before funding the loan. Additionally, if a venture is largely tied to one large equity owner such as a large hospital or other tax-exempt entity with investment grade credit, the lender should make sure that there are adequate safeguards in the borrower's internal governing documents to prevent major equity holders from withdrawing from the company, or at least making the withdrawal or transfer of a significant portion of equity an event of default.

7. Events of Default.

On the lender side of the transaction, counsel should make sure that the lender is protected against the loss of a management company or other key corporate sponsor or member of the borrower. This can be accomplished in several ways, but is usually done by way of prior approval or notification requirements and corresponding events of default. This will allow the lender to ensure that a hospital or parent company will remain with the borrower for the duration of the borrower's obligations to lender. This is especially important in the case of corporate guarantees. Borrowers should attempt to include language in the documents which would allow minor changes in ownership (such as changes in ownership less than a specified amount or a percentage in the aggregate over a period of time) in situations where the membership of a particular company changes regularly. Finally, where the death or disability of a debtor or guarantor can trigger an event of default as to the entire loan facility, a borrower with many owners or members should ensure that the death or disability of one of its own minority members does not trigger an event of default for the company.

As a safeguard against insolvency and the threat of being unable to collect amounts due from the borrower in the event of a default, lenders sometimes incorporate the use of financial covenants in an

attempt to ensure that the borrower has enough cash on hand to pay its debts. For example, it is not uncommon to see a financial covenant that requires a company to maintain a debt coverage ratio (usually the ratio of all debt payments to cash flow or EBITDA measured quarterly or monthly) in order to avoid default. This type of covenant allows a lender to move against the assets of the borrower or accelerate payments before its collateral assets (in some cases accounts) have been liquidated or used to pay other debts, or prior to the borrower becoming insolvent.

8. Landlord and Real Property Issues.

When attempting to perfect a security interest on a heavy piece of machinery or other items of personal property that have the risk of becoming fixtures of a piece of real estate, special care needs to be taken to obtain a waiver of rights in the personal property from the landlord of the borrower. It is often a difficult task to obtain a waiver from a landlord because the landlord has no real incentive to bargain with the lender as a third party to the lending transaction. Frequently, landlords will negotiate items contained in waivers such as the right of entry, the right to reclaim personal property, the right to sell the personal property on the premises and the right of the lender to receive notice in the event of a default or foreclosure as a result of failure to pay rent. The negotiation process for any landlord waiver document should be started in a timely manner in order to ensure that negotiation of this document is completed by the time the loan transaction is scheduled to close. Additionally, in any case, lenders should ensure that all leases relating to real property that is used in the borrower's operations are at least coterminous with the term of the loan or loans included in the financing package.

9. Subordination and Guarantees.

Lenders will often try to subordinate any distributions from a company to its members or partners. This is done in order to prevent the borrower, upon the occurrence of an event of a default, from making distributions to its members or partners of the remaining assets of the Company. Without a subordination of distributions, a borrower could potentially make itself "judgment proof" by distributing all cash

on hand to its members, thus leaving nothing for a foreclosing creditor to seize. The definition of "distributions" or of the types of payments that are subordinated can be adjusted to fit the specific needs of the borrower. Typically, borrowers show a preference for excluding operating expenses from the subordinated payments. This allows the borrower to continue to operate in light of a default.

Guarantees provide another method of securing debt where little or no collateral is available or where the lender is unwilling or unable to offer non-recourse loans. The guarantees may be joint or several or may be limited to a member's or partner's pro rata share based upon percentage of ownership in the company. For startup projects, guarantees may be used to cover only the construction period with liens on equipment and assets taking the place of the guarantees after operations begin.

10. Prepayment.

Though not exclusive to healthcare lending transactions, borrowers should attempt to negotiate for the ability to prepay the outstanding principal of the loan. Lenders can often be wary of allowing prepayment as it can cut into the interest payments and the profit margin on the loan. A compromise can often be reached by allowing prepayment after a period of time has passed or upon satisfaction of various financial covenants by the company related to debt service ratio or EBITDA. Another solution is to allow prepayment with a prepayment fee of a predefined percentage (usually lower than the applicable interest rate) or a prepayment fee that reduces over the life of the loan. As amortization methods can vary greatly, borrowers should procure an amortization schedule along with the repayment schedule for the loan, as the amount of each payment that is being used to repay the principal balance of the loan is often as important as the total amount of each payment.

Conclusion

Lenders can often become frustrated with less sophisticated borrowers or those who are unaccustomed to industry-specific credit requirements. All too often borrowers -especially smaller enterprises -feel overwhelmed by the restrictions and requirements of lending institutions. By understanding the

motivations on either side of the negotiating table, both parties can benefit from an enhanced awareness and familiarity with the healthcare lending process.