LANDLORD CONSIDERATIONS IN LEASE WORKOUTS WITH TROUBLED HEALTHCARE OPERATORS

Including Bankruptcy Considerations

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The past few years have seen an unprecedented number of bankruptcies in the healthcare space, primarily from hospitals and senior living operators. The pressure placed on healthcare operating companies will only increase as they deal with the effects of the COVID-19 pandemic and continued downward pressure on reimbursements. As the owner of the real estate leased to these operators, the landlord has a large stake in the success of the healthcare business being conducted on its premises, and needs to understand the drivers of the underlying business model in order to assess the risk profile of the tenant operator. This understanding should allow the landlord to detect the early warning signs of distress and take proactive steps toward nursing the operator back to health. While a failing tenant is not the landlord's fault or responsibility, it often does become the landlord's problem, and a landlord with healthcare tenants has many factors to consider that landlords of other asset classes do not. This article will address the unique nature of the healthcare tenant/operator, as well as some strategies and tactics for landlords to consider when working with a troubled healthcare tenant.

Detecting the Early Warning Signs

As a general rule, most healthcare tenants are less impacted by general economic downturns than other types of tenants. Healthcare tenant issues are more often driven by poor operational decisions or factors unrelated to the general economy but otherwise completely out of the tenant's control (such as demographic changes in its patient population to more uninsured and Medicare/Medicaid patients or changes in the regulatory environment or the tenant's payer contracts). As a result, healthcare tenant financial issues are often more challenging for a landlord to predict or identify early. Nevertheless, the landlord can attempt to detect the early warning signs of a tenant in trouble by:

- Educating itself on the tenant's business and seeking to understand the tenant's underlying business drivers, such as patient demographics, payer mix and type of specialty;
- Reviewing the tenant's financials if the landlord has the right to do so under the lease and, if not, including such right to receive tenant financials as a condition to any future lease amendment;
- Determining if any other tenants in the same line of business and in the same geographic area are having financial issues; and
- If the tenant has been late on rent or other payments under the lease, taking note as to whether this occurrence is any different than the tenant's past payment practices.

The earlier the landlord can detect signs of financial distress with a tenant, the better the landlord can deal with the fallout. Often, leases can be restructured to save the tenant, or a replacement tenant can be found early in the process in order to avoid a potential lease default or tenant bankruptcy.

The Workout Phase – Is This a Marriage Worth Saving?

Once the tenant begins to show the signs of financial strain, a conversation will likely ensue. Either the tenant will proactively call the landlord to discuss the situation prior to

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skipping the next rent payment or the rent simply won't show up, with the tenant waiting for the landlord to respond. This often triggers the commencement of the lease workout, which the landlord should navigate by taking the following steps.

Determine Your Objectives. First, the landlord should attempt to determine its objectives for the lease workout, which may include:

- Preserving the long-term rental stream generated by the lease by keeping the tenant for the remainder of the lease term. This may be beneficial when dealing with a good tenant going through a temporary rough patch, and may mean restructuring the lease payments either through: (i) a rent abatement for a period of time, possibly coupled with an extension of the lease term; (ii) a temporary rent deferral with an amortized repayment obligation over time; or (iii) a permanent reduction in rent;
- Attempting to preserve a short-term rental stream (or at least a rent payment obligation) by keeping the tenant in place while beginning to look for a replacement tenant in earnest. This approach may make sense when dealing with an adequate tenant with some resources, but with a less than desirable long-term outlook. The focus here is to squeeze as much as possible from the tenant in the short term while looking for the replacement tenant;
- Replacing the tenant immediately to cut losses and avoid dealing with the lease in bankruptcy. This method is often appropriate when dealing with a chronically bad tenant with no discernable resources to chase; or
- Replacing the existing tenant while attempting to preserve the applicable provider license or certificate of need ("CON"). This approach will require the cooperation of the tenant for continued operation of the business at the premises.

If the landlord determines that the best course of action is the replacement of the tenant, the landlord needs to understand the type of provider involved as well as the impact a change in tenant will have on the applicable healthcare license or certification status. The landlord must also consider whether a new CON will be needed to allow for a change in tenant.[2] Provider licenses and CON are state law specific and are held by the tenant as the operating entity. Moreover, neither a provider license nor a CON are generally assignable or transferable. Therefore, the landlord should familiarize itself with how a change in the tenant impacts change of ownership ("CHOW") processes, whether a change in the tenant requires a new CON, and if a change in the tenant is possible under the needed timeframe for the transition.

If a new tenant is ready to step in and take over operations, this process may involve a lease termination with a short-term Operations Transfer Agreement to allow the current tenant to continue operating on behalf of the new tenant in an effort to allow the effective transition of the license or CON through available CHOW mechanisms. This includes analysis of whether to enter an ownership interest transfer agreement, an asset purchase agreement or some other type of transition arrangement. The parties must also consider how to transition patient care[3] as well as how to transition payer arrangements to ensure that the new tenant can provide, bill and collect for services as quickly as possible. Like healthcare licenses and CON, most payer agreements of an existing healthcare provider are not assignable or transferable to a new provider.

Understand Your Available Remedies. Second, the lease should be reviewed to determine the universe of remedies available to the landlord and the attractiveness of each remedy in light of the landlord's objectives. These remedies will typically include:

- An action against the tenant for unpaid rent, which may or may not be an acceptable remedy depending on the financial standing of the tenant and the availability of any credit enhancements such as guaranties or letters of credit;
- Termination of the tenant's possession of the premises without terminating the lease, which leaves the tenant liable for future lease payments as they come due, but again depends on the tenant's ability to pay; and/or
- Termination of the lease, which leaves the tenant liable to the landlord for liquidated damages (generally calculated as the sum of the lease payments over the remainder of the term, less the fair market rental value of the premises for the remainder of the lease term.)

In many cases, the landlord may also have a credit enhancement in the form of a security deposit, letter of credit or lease guaranty. Understanding the differences in these credit enhancement vehicles and their relative value becomes critical in a lease workout. For example, both the letter of credit and the guaranty can be realized upon even after the tenant files for bankruptcy protection, while the cash security deposit cannot. Also, the amount of the credit enhancement and the creditworthiness of the guarantor(s) may factor into the landlord's strategy with respect to termination of the lease.

Potential Impediments to the Enforcement of Remedies. In reviewing the remedies available under the lease, the landlord must remember that several issues unique to the enforcement of remedies under healthcare leases will be in play. For example, regulatory requirements governing the closing of facilities such as hospitals, assisted living facilities or skilled nursing facilities often require notice of such closing, both to patients so that they can find alternative care arrangements and to the applicable state regulatory agencies so that they are aware of changes to the provider. These types of requirements often rest with the tenant provider, not the landlord, and must be accomplished long before terminating the lease.

Additionally, the landlord must address practical considerations in exercising its remedies under the lease for certain healthcare facilities. These include things such as: (a) the impossibility of locking out a tenant hospital or skilled nursing facility containing patients or residents; (b) the need to execute a short-term lease, license agreement or Operations Transfer Agreement with the defaulted tenant to keep the facility open and operational during the transition to a new tenant; (c) the need to assist the new tenant with any CON or other CHOW process to finalize the transition; and (d) assuring that neither the landlord nor any other party violates HIPAA (or applicable state law) requirements that protect the medical records of the tenant.

Finally, it is important that the landlord remembers that the tenant as the healthcare

[2] Certificates of need are required in 35 states, with Texas and California among the states where they are not required.

[3] Most states have specific notice obligations to patients regarding closure of an existing healthcare provider and options for transition of patient care to a new provider.

provider is the legal entity responsible for patient care and compliance with any applicable healthcare regulations. As such, much of success of a proposed transfer of operations to a new tenant depends on the cooperation of the departing tenant. The landlord must therefore approach default and termination decisions in a way that maximizes the likelihood that the departing tenant will cooperate in the transition of healthcare operations to a new tenant. Of course, if the departing tenant wants out of its lease obligation, it is likely to cooperate in the transition to a new tenant in exchange for a release of liability under the lease moving forward. However, if the departing tenant decides to be difficult, the landlord may have to weigh the consequences of a lease termination without a smooth operational transfer.

Laying the Groundwork – Reservation of Rights. After reviewing and analyzing the landlord's remedies from both the legal and the practical standpoint, a notice of default and reservation of rights letter should be sent to the tenant. Regardless of whether the landlord intends to take immediate action, the landlord should promptly send such letter and, in doing so, the landlord must follow the lease requirements for notice including, if applicable, provide the tenant with an opportunity to cure the default within the timeframe set forth in the lease. This allows the cure period to run so that the next step can be taken quickly, if necessary. The notice letter should include a demand for past due rent and any other past due payments (e.g., common area maintenance charges, taxes, etc.), together with any interest and late fees allowed by the lease.

Identify any Competing Claims on FF&E. Next, a determination should be made as to any competing claims to the tenant's furniture, fixtures and equipment ("FF&E") located at the premises, which of course can be quite valuable in healthcare spaces and very attractive to a potential replacement tenant. In this regard, the landlord should determine:

- What FF&E at the premises is owned by the tenant versus what FF&E is leased;
- Whether the lease between landlord and tenant provides for a landlord's lien on the tenant's FF&E and, if so, if the landlord's lien is subordinate to the tenant's equipment financing; and
- If the landlord has no claim to the FF&E or its claim is subordinate to another, will the premises be more marketable with the FF&E and, if so, the landlord must negotiate with the holder of the superior interest in the FF&E. Generally speaking, an equipment lender will not want to remove the equipment from the premises except as a last resort, so the landlord (or a replacement tenant) may be able to negotiate a price to keep the FF&E that will add value to the premises.

If the landlord determines it does not want or need the FF&E, then it must make arrangements for the removal of same without damage to the premises or the FF&E. It should be noted that, in some cases, it might be difficult to distinguish FF&E from fixtures that are attached to and legally a part of the real estate.

Weigh the Consequences of a Tenant Bankruptcy Against the Landlord's Objectives. Finally, the landlord should weigh the consequences of a potential tenant bankruptcy against the landlord's objectives described above. Factors for the landlord to consider are:

- The likelihood that the tenant assumes or rejects the lease and the timeframe that the tenant has to make such decision;
- Whether the landlord is willing to provide some rent relief or concessions to the tenant as part of a bankruptcy plan of reorganization;
- What the tenant's business will look like post-bankruptcy;
- Whether the tenant can actually survive bankruptcy and, if so, what other challenges will it face; and
- Whether there are there any avoidance or other potential liabilities to consider.

If the landlord desires to avoid being drawn into the tenant bankruptcy, the landlord must terminate the lease prior to the tenant's filing. Of course, the landlord must balance the operational, licensing and regulatory issues discussed above against the desire to be free from the bankruptcy to determine if termination pre-bankruptcy is the appropriate course of action.

The Bankruptcy Phase

Once the tenant files for bankruptcy protection, the rules of the game change. The landlord no longer may unilaterally terminate the lease and no longer may pursue a separate action for past due rent. Some key bankruptcy issues for the landlord to understand are addressed below:

The Automatic Stay. The automatic stay is essentially an injunction under the United States Bankruptcy Code (the "Code") that generally halts actions by creditors to collect pre-bankruptcy debts from a debtor who has declared bankruptcy. Under Section 362 of the Code, the stay begins at the moment the bankruptcy petition is filed, and unless terminated or modified, it lasts throughout the case. The automatic stay is very broad and it applies to any act to obtain possession of, or exercise control over, property of the bankruptcy estate.

As a result of the automatic stay, the landlord can no longer terminate the lease unilaterally and must wait for the tenant's decision to assume or reject the lease, or move to terminate the automatic stay for cause, in order to terminate the lease or otherwise enforce its rights under the lease. The landlord may obtain relief from the stay for "cause" based on the factual circumstances, including the lack of "adequate protection," such as the non-payment of rent or violation of other lease terms.

However, a tenant bankruptcy is not all bad news for the landlord. Absent further order of the court, the automatic stay generally does not apply to non-debtor parties, such as principals or guarantors, so the landlord can elect to pursue these third parties separately, if appropriate. In addition, once the stay is in place, the tenant is generally required to pay its rent and comply with its lease while the tenant decides to assume or reject the lease. If the tenant fails to do so, the landlord can request the bankruptcy court to compel the debtor to promptly make a decision on assumption or rejection. Conversely, the court may grant, for cause, the tenant an extension of its post-bankruptcy lease obligations, during the first 60 days of the bankruptcy case. Due to the COVID-19 pandemic, certain courts have found sufficient cause to extend this deadline (e.g., Pier 1 Imports, Modell's and Craftwork Holdings). Finally, during this interim period prior to the tenant electing assumption or rejection of the lease, if the tenant wishes to stay in the premises, it may still ask for past or future rent relief (or other commissions) from the landlord, but the landlord is under no obligation to agree. In any event, tenants often use the specter of rejection and further delay to encourage the landlord to grant rent concessions.

363 Sale Issues. A 363 Sale refers to a sale of the debtor's assets under Section 363 of the Code and allows the tenant to sell estate assets "free and clear" of liens, claims and encumbrances, subject to bankruptcy court approval. This process is similar to an auction outside of bankruptcy. Typically the debtor and its professionals run the sale process, but a sale requires bankruptcy court approval. Under a 363 Sale, the lease may be assumed or assumed and assigned to a third-party purchaser as part of a sale. However, while the landlord may not have a veto over who the lease is assigned to, any modifications to the lease (including rent concessions) must be approved by the landlord.

Assumption or Rejection. As previously mentioned, once the bankruptcy case is filed, the tenant/debtor gains a measure of control over the fate of the lease. The lease may be rejected, assumed, or assumed and assigned. If the lease is rejected, it is treated as a breach of the lease and the landlord has a claim for "rejection damages." However, damages for long-term leases are capped. The tenant must assume or reject the lease within the earlier of 120 days after the date the bankruptcy is filed or the date an order confirming a bankruptcy plan is entered. The 120-day deadline can be extended an additional 90 days for "cause," but it cannot be further extended absent the written agreement of the landlord.

If the tenant desires to assume the lease, it must do two things:

- Cure all monetary defaults under the lease (including all pre-bankruptcy amounts, possibly including attorney's fees if the lease terms require it). The cure does not require an immediate cash payment, and the bankruptcy court has broad discretion to allow an extended cure; and
- Provide adequate assurance of future performance (i.e., evidence of the ability of the tenant or assignee of the tenant to perform under the lease). This may be difficult for a tenant or assignee to demonstrate and is often the landlord's protection against an assignment to a new tenant that lacks sufficient resources to perform under the lease.

Interplay with Regulatory Issues. As discussed above, there are a number of regulatory considerations for a change in healthcare provider tenants, including, among others, CHOW processes, CON approvals, termination and issuance of a new license, credentialing of payer contracts, and notices to patients of need to transfer providers. If the transition process has not begun, an intervening bankruptcy filing will likely halt any change in the provider entity and require bankruptcy court approval for each process in the transition. The new tenant may even need leave from the bankruptcy court to continue with any CON or CHOW filings, depending on the requirements for the processes under state law. This means that the bankruptcy court could order the applicable state agency to halt proceedings and not make any CON or CHOW determinations until further notice.

If the transition process has begun, the bankruptcy proceeding could impact how the parties proceed with any transaction to facilitate the transfer of operations to the new provider entity, whether it be a purchase of ownership interests or assets by the new provider entity. This process will need to be carefully coordinated among the current tenant, new tenant and landlord.

Other Bankruptcy Issues. There are a number of other issues that might be encountered by a landlord in any bankruptcy, including the confirmation of a plan of reorganization (or liquidation), assertion and allowance of an administrative or rejection damages claim and conversion or dismissal of the case. These issues could impact the landlord and should also be evaluated in formulating a strategy in dealing with the bankrupt tenant.

Conclusion

With the increased number of bankruptcies occurring in the healthcare space, landlords with healthcare operators as tenants are well served to become familiar with their tenants' businesses so as to be able to detect the early warning signs of financial issues with their tenants and take proactive steps toward nursing the tenant back to health. When a lease workout becomes necessary, the landlord must systematically (i) identify its goals and objectives with respect to its struggling tenant, (ii) evaluate the options it has available as remedies under the lease and the limitations imposed on such remedies (both legally and practically) and (iii) analyze the potential impact a tenant bankruptcy might have on the landlord's objectives.

Successfully navigating these issues requires a team with knowledge and expeience in real estate, healthcare and bankruptcy law. Winstead's Healthcare Real Estate Practice stands at the intersection of these three diverse areas of the law, and we have extensive experience in guiding our healthcare landlord clients through the myriad issues that arise in these complicated transactions.

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