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Do Two Make a Trend?

The Resurgence of Medicare and Medicaid Provider Agreements as Statutory Entitlements

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Two recent decisions, one from the U.S. Bankruptcy Court for the District of Delaware and one from the U.S. Bankruptcy Court for the Central District of California, demonstrate that the conventional belief that Medicare and Medicaid provider agreements are executory contracts that must be assumed and assigned to a purchaser of the debtor's assets might be on uncertain footing.[1] Both decisions held that Medicare and Medicaid provider agreements are statutory entitlements capable of being transferred to prospective purchasers under §§ 363(b) and (f) of the Bankruptcy Code free and clear of all interests, claims and encumbrances, including the regulatory and pecuniary interests of the Centers for Medicare and Medicaid Services (CMS)[2] and state Medicaid agencies. Although one decision was subsequently vacated as moot, and the other decision is currently on appeal, should the holding be affirmed,[3] health care debtors will be provided with a powerful tool for monetizing provider agreements without the necessity of payment of cure costs or the risk of successor liability under such agreements.

The *Hahnemann* Decision[4]

Center City Healthcare LLC d/b/a Hahnemann University Hospital and certain of its affiliates (collectively, "Hahnemann") filed for bankruptcy with the goal of selling the assets related to its 496-bed academic medical center. As part of the sale of its assets, Hahnemann sought to sell certain graduate medical education residency slots, provided by Hahnemann's Medicare provider agreement, free and clear of all liabilities and interests.

Hahnemann filed bidding procedures with a stalking-horse bid of $7.5 million. After a robust auction, a consortium of local hospitals agreed to purchase the residency slots for $55 million. CMS filed a number of objections to the sale of the residency slots. While many of CMS's objections focused on Hahnemann's ability to sell the residency slots at all, CMS also argued that if Hahnemann was able to transfer the residency slots to the purchaser, it could only do so by satisfying the requirements of § 365 related to executory contracts, which would require, among other things, the cure of all defaults under the provider agreement and full successor liability on the part of the purchaser.

The Delaware bankruptcy court overruled CMS's objections and specifically found that Hahnemann's Medicare provider agreement did not meet the definition of an "executory contract" in the Third Circuit.[5] Instead, the court found that Hahnemann's Medicare provider agreement was a statutory entitlement capable of being sold free and clear of all interests and successor liability under § 363. The bankruptcy court analogized the Medicare provider agreement to a license issued by a government agency, which have been held by other circuits to be property of the debtor's estate and, thus, transferable pursuant to § 363.[6]

1 *In re Verity Health Sys. of Cal. Inc.*, 606 B.R. 843 (Bankr. C.D. Cal. 2019), *vacated as moot*, 2019 WL 7288754 (Bankr. C.D. Cal. Dec. 9, 2019); *In re Ctr. City Healthcare LLC*, Case No. 19-11466 (KG) (Bankr. D. Del. Sept. 10, 2019) (ECF No. 681).

2 CMS is a component of the U.S. Department of Health and Human Services (HHS).

3 The decision in *In re Verity Health Sys. of Cal. Inc.* was vacated on Dec. 9, 2019, upon the entry of an agreed stipulation regarding the assumption and assignment of the provider agreements.

4 *In re Ctr. City Healthcare LLC*, Case No. 19-11466 (KG) (Bankr. D. Del. Sept. 10, 2019).

5 In doing so, the court stated that CMS's reliance on *In re University Medical Center*, a Third Circuit case often cited for the proposition that provider agreements are executory contracts, was misplaced because the Third Circuit merely assumed that provider agreements are executory contracts without engaging in any analysis or finally deciding the issue. *See* 973 F.2d 1065 (3d Cir. 1992).

6 *See In re Tak Commc'ns Inc.*, 985 F.2d 916, 918 (7th Cir. 1993).

The *Verity* Decision[7]

Verity Health System of California Inc. and certain of its affiliates (collectively, "Verity") also filed for bankruptcy with an eye toward selling several hospitals operated in California. Verity entered into an asset-purchase agreement to sell four of its hospitals, each of which had been obligated, pursuant to their Medi-Cal[8] provider agreement, to pay quarterly hospital-quality assurance fees (HQAFs) to the California Department of Health Care Services (DHCS). DHCS contended that Verity was liable for approximately $30 million of unpaid HQAFs and for approximately $25 million of fee-for-service overpayments under the Medi-Cal provider agreement.

As such, DHCS argued that the unpaid HQAFs and overpayments must be cured in order for the Medi-Cal provider agreement to be assumed and assigned to the purchaser. Verity argued that the provider agreements were instead property of its estate and thus could be sold free and clear of the unpaid HQAFs and overpayments under § 363.

The California bankruptcy court agreed with Verity and, as in *Hahnemann*, held that the provider agreements were statutory entitlements that Verity could sell free and clear of all liabilities to DHCS, rather than executory contracts requiring assumption and cure.[9] In reaching its conclusion, the bankruptcy court found that the right to receive payment under the provider agreements is a manifestation of government policy, not a contractual right, and that the Medi-Cal provider agreement lacked a key feature found in all executory contracts: obligations imposed on both sides. The court concluded that the Medi-Cal provider agreement imposed no obligations on DHCS and that Verity's obligations under the Medi-Cal provider agreement were nothing more than pre-existing legal obligations.[10] Also, like the Delaware bankruptcy court in *Hahnemann*, the California bankruptcy court analogized the transfer of the provider agreements to the sale of government licenses in holding that the provider agreemenst were property of the estate capable of transfer under § 363[11] and stated that other court decisions finding that provider agreements were executory contracts either assumed that outcome or were decided without meaningful analysis.[12]

The California bankruptcy court specifically held that the Medi-Cal provider agreements could be transferred free and clear of the unpaid HQAFs and overpayments under § 363(f)(5), which provides that property of the estate may be sold free and clear of an interest if the entity holding the interest "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[13] Thus, it found that since DHCS's interest in the Medi-Cal provider agreements "would be extinguished if it received the payments it contends it is owed," DHCS could be compelled to accept a money satisfaction of its interest.[14]

7 *In re Verity Health Sys. of Cal. Inc.*, 606 B.R. 843 (Bankr. C.D. Cal. 2019), *vacated as moot*, 2019 WL 7288754 (Bankr. C.D. Cal. Dec. 9, 2019).
8 Medi-Cal is California's state Medicaid program.
9 *See In re Verity Health Sys. of Cal. Inc.*, 606 B.R. at 848-51.
10 *See id.*
11 *See In re Fugazy Exp. Inc.*, 124 B.R. 426, 430 (S.D.N.Y. 1991).
12 *In re Verity Health Sys. of Cal. Inc.*, 606 B.R. at 851.
13 11 U.S.C. § 363(f)(5).
14 *In re Verity Health Sys. of Cal. Inc.*, 606 B.R. at 854.

What Is Next for Health Care Debtors?

While the *Hahnemann* and *Verity* decisions appear, at first glance, to be a boon for health care debtors seeking to monetize all of the assets in their estates, the outcome is far from certain. CMS has appealed the *Hahnemann* decision, which has been fully briefed on appeal before the U.S. District Court for the District of Delaware. In addition, the California bankruptcy court in *Verity* refused to include in the sale order that DHCS's recoupment rights "must be first exercised against payments due to [Verity] from Medi-Cal, then against funds held by [Verity] generated by past interim Medi-Cal payments, and then against any sale proceeds generated by the sale" of the Medi-Cal provider agreement.[15] This request was declined by the bankruptcy court because "the issue of the applicability of recoupment subsequent to the sale of the [Medi-Cal provider agreements] free and clear of claims and interests ha[d] not been sufficiently briefed."[16] While it is not clear why Verity failed to brief the issue of whether a state Medicaid agency nonetheless has recoupment rights to collect overpayments from its participating health care debtor even when a provider agreement is sold free and clear of all liabilities, there is a possibility that it could have received a favorable ruling had it done so.

The U.S. Bankruptcy Court for the District of Massachusetts ruled on the issue of recoupment in *In re Vitalsigns Homecare Inc*.[17] Vitalsigns Homecare Inc., f/k/a Holden Homecare Services, filed a voluntary petition pursuant to chapter 11, and six weeks later, when Vitalsigns's operations had halted, the case was converted to chapter 7.[18] Simultaneously with the conversion, the chapter 7 trustee transferred Vitalsigns's patients to several different home health care agencies, one of which was not, at the time, an approved Medicare provider.[19]

Shortly thereafter, the chapter 7 trustee filed a motion to sell the Medicare provider number and the entitlements associated therewith "free of liens, claims, and encumbrances to" the potential purchaser.[20] The trustee expressly noted in its motion that one of the claims that it wished to discard "is [the HHS's] right to recoup overpayments from future Medicare payments."[21]

The Massachusetts bankruptcy court held that HHS can recoup overpayments from the buyer *only after* it first recoups (1) "overpayments from any payments due to the Debtor's estate" (2) "against funds held by the Trustee if such funds were generated by the past interim Medicare payments" and (3) "against any sale proceeds generated by the sale of the provider number."[22] However, even though the Massachusetts bankruptcy court ruled on the recoupment issue, it refrained from ruling as to whether a provider agreement was an executory contract or a statutory entitlement. It reasoned that "when two statutes are capable of co-existence [*i.e.*, the Medicare and bankruptcy statutes], it is the duty of the courts, absent a clearly expressed congressional inten-

15 *Id.*
16 *Id.*
17 396 B.R. 232, 241 (Bankr. D. Mass. 2008).
18 *Id.* at 233-34.
19 *Id.* at *234.
20 *Id.*
21 *Id.*
22 *Id.* at 241.

tion to the contrary, to regard each as effective."[23] Further to the Massachusetts Bankruptcy Court's point, it believed that "courts [are] not at liberty to pick and choose among congressional enactments."[24] Nonetheless, the court was still able to find common ground and ultimately ruled that "[r]equiring the provider agreement to be assumed prior to its sale ... harmonizes both the Medicare and Bankruptcy statutes"[25] without having to decide the categorization of a provider agreement.

Other courts, including the Delaware and California bankruptcy courts, have had no problem siding with one statute over another. Among these is also the U.S. District Court for the Middle District of Florida, which held, in part, that a provider agreement is a statutory entitlement and reasoned that "[t]he rights and duties of [CMS/HHS and health care providers] are set forth not in provider numbers but rather in the Medicare Statutes and Regulations."[26] Based on this rationale, the Florida bankruptcy court found that provider agreements, as statutory entitlements, could be sold "free and clear of HHS recoupment interest in [the debtors'] property."[27]

The holdings set forth in *Vitalsigns* and *B.D.K.* were exactly what the debtors in *Verity* wanted. Had Verity been briefed, and the California bankruptcy court subsequently ruled on, the issue of recoupment in a similar manner as the Massachusetts and Florida bankruptcy courts, Verity could have successfully established precedent that not only characterized provider agreements as a statutory entitlement but also that provider agreements can be sold to a buyer free and clear of all future claims and liabilities, including the state Medicaid agency's right of recoupment. However, the California bankruptcy court's refusal to include in its order Verity's request related to the recoupment of overpayments might very well make the decision lose some of its utility to health care debtors.

In any event, the *Hahnemann* and *Verity* decisions give health care debtors significantly more leverage over CMS and state Medicaid agencies in bankruptcy. In most health care cases involving a sale under § 363, debtors have found it easier to accede to the government's position on provider agreements and negotiate favorable terms of assumption and assignment within the framework of provider agreements as executory contracts. Now that recent decisions in high-profile chapter 11 cases have held unequivocally that provider agreements are statutory entitlements, there appears to be little that CMS or state Medicaid agencies can do to exert pressure on health care debtors to accede to the government's terms.

Similarly, health care debtors have long viewed provider agreements as a necessary evil in the context of a chapter 11 case. The importance of negotiating with the government over the terms of assumption and assignment often necessitated, at the very least, reserving amounts sufficient to cure defaults under the provider agreements from sale proceeds. Perhaps more importantly, the threat of successor liability against the purchaser, as well as the uncertainty of negotiating with the government or potentially having to obtain a new provider agreement, detrimentally affected the price that purchasers were willing to pay for health care assets. Being freed from the constraints of the executory contract framework and being able to price deals as truly free and clear sales will increase the value of health care debtors' estates. abi

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23 *Id.* at 240 (citing *Morton v. Mancari*, 417 U.S. 535, 551 (1974)).
24 *Id.*
25 *Id.*
26 *In re B.D.K. Health Mgmt. Inc.*, Case No. 98-00609-681, 98-00610-681, 98-00612-681, 98-00613-681, 1998 WL 34188241 at *6 (Bankr. M.D. Fla. Nov. 16, 1998) (citing *Mem'l Hosp. v. Heckler*, 706 F.2d 1130, 1136 (11th Cir. 1983)).
27 *Id.*