# Restructuring Challenges of Tax-Exempt Bond Financing for Health Care Facilities

#### **Contributing Editor:**

Nancy A. Peterman Greenberg Traurig LLP; Chicago petermann@gtlaw.com

### Also Written by:

David D. Cleary Greenberg Traurig LLP; Phoenix clearyd@gtlaw.com

Elizabeth J. Sickelka Greenberg Traurig LLP; Chicago sickelkab@gtlaw.com

The recent economic downturn has impacted virtually every industry, necessitating creative, expedited and, at times, complicated workouts, restructurings and bankruptcy filings. However, few industries have presented as many challenges to restructure as has the nonprofit health care industry. Nonprofit status, attorney general involvement, adherence to mission statements, funding concerns and patient care are just a few of the factors that must be considered when restructuring a health care facility. These issues are further complicated where the health care facility is financed by tax-exempt bonds.

## An Overview



Nancy A. Peterman

While some nonprofit health care entities may have traditional taxable financing, these entities are increasingly funded by low-interest, taxexempt bond debt. This type of financing often replaces other alternative

sources, including charitable donations and grants, both of which have become scarce in today's economy. While there are certain advantages to tax-exempt financing, this type of financing leaves health care facilities with limited options when they experience financial distress.

The advantage of tax-exempt financing to the health care facility is that the interest payable on the debt is exempt from federal and, often, state income taxation. Because of the bonds' tax-exempt status, investors will typically buy the bonds at lower interest rates than they would demand on comparable taxable corporate securities, allowing the health

## About the Authors

Nancy Peterman is chair of Greenberg Traurig's Business Reorganization and Bankruptcy Department in Chicago, member of ABI's Board of Directors and former co-chair of ABI's Health Care Insolvency Committee. David Cleary is chair of Greenberg Traurig's Business Reorganization and Bankruptcy Department in Phoenix. Beth Sickelka is an associate in Greenberg Traurig's Business Reorganization and Bankruptcy Department in Chicago.

care facility to achieve lower interest rates on financing. Another advantage of tax-exempt bonds is that they are exempt from many of the registration requirements of federal and state securities laws (though certain requirements do pertain to tax-exempt bonds, including anti-fraud provisions and insider trading rules). These regulatory exemptions can Code. Achieving and maintaining the tax-exempt status, therefore, is conditioned upon compliance with numerous rules regarding the types of projects that can be financed, the use and sale of the any assets financed by the bond issue, the investment of the bond proceeds and limitations on refinancing. It is these limitations that become important in a restructuring context, where one of the primary concerns is ensuring that bond debt maintains its tax-exempt status.

While the basis for most of the use limitations on tax-exempt bonds is federal and state law, the analysis also must focus on the finance documents that evidence the limitations specific to a particular bond issuance. Generally, there are three primary financing documents that govern how the tax-exempt bonds can be used: the (1) trust (or bond) indenture; (2) loan agreement; and (3) security document.

The trust indenture is an agreement between the public issuer of the bonds and

## Intensive Care

make the bonds less expensive to issue and maintain than traditional security offerings. Because of the tax and regulatory advantages of tax-exempt bonds, they are available only to a statutorily limited pool of organizations, including most nonprofit health care facilities.

Tax-exempt bonds are issued by a public issuer to investors, and the proceeds of the issuance are lent to the borrowing health care facility. The health care facility assumes responsibility for repayment of the bond debt and payment of interest on the debt to the bondholders. Because of their tax-exempt status, these bonds are attractive to a variety of investors, which can be institutions (such as mutual funds) or individuals. The bonds can be purchased through a private placement or a limited or public offering through an underwriting by an investment banking firm. In any case, the investors are purchasing the bonds with the goal of making a profit, not as a charitable or philanthropic venture.

The basis for the bonds' tax exemption is statutory and can be found in state statutes and the Internal Revenue

the bond trustee who is appointed to act as the fiduciary on behalf of the bondholders. It typically specifies the bond terms, interest rates, amortization schedule, events of default, remedies and rights, and responsibilities of the bond trustee. Some trust indentures establish funds, which the bond trustee manages in trust for the bondholders.

The loan agreement, as the name suggests, evidences the loan of bond proceeds from the public issuer to the borrower as well as the borrower's repayment obligations. The loan agreement is essentially the same as any traditional loan agreement and will contain certain financial covenants, limitations and other business conditions. One of the differences between a traditional loan agreement and a loan agreement relating to a bond issuance is that in a bond-based loan agreement, the issuer's rights are usually assigned to the bond trustee, who will have the power to enforce the borrower's repayment obligations and the covenants on behalf of the bondholders. This assignment is generally contained in the trust indenture.

continued on page 72

18 December/January 2011 ABI Journal

## Intensive Care: Restructuring Challenges of Tax-Exempt Bond Financing

from page 18

Depending on the borrower's credit, it is not uncommon for health care bond financings to include a lien on the revenues or certain assets of the health care facility. In this case, there will also be security documents executed as part of the loan. Generally, the indenture trustee is the lienholder for the secured assets. and, as part of the lien and as discussed, will hold certain of the borrower's funds in reserve as a fiduciary for the bondholders. While the purposes of these funds vary and will be specified under the trust indenture, they are often used to pay the bondholder's costs and expenses or to cover shortfalls in the borrower's principal or interest payments. The trustee is bound to use these funds for the purposes described in the trust indenture, and, in a restructuring context, these funds are usually not available for general purposes or for working capital, at least not without jeopardizing the bond's tax-exempt status. However, these funds may at times be a source of financing for a health care facility's bankruptcy case, depending on the specific language of the relevant documents.

## **Consent Requirements**

In addition to the use limitations on tax-exempt bond proceeds and funds, there are consent requirements, which can be quite cumbersome when attempting a workout or restructuring. As described, bonds are typically held by numerous individuals and institutions. The trust indenture usually provides the bond trustee with some latitude in making decisions on behalf of these bondholders, but there are often consent requirements for major decisions. These consent requirements can be triggered by any change to the terms of the loan agreement, by a default or by a restructuring. In these cases, trust indentures may require the bond trustee to obtain the consent of a certain percentage (for some decisions, 100 percent) of the underlying bondholders.

Consent requirements vary among trust indentures, but are generally related to the number of anticipated bondholders, as well as their sophistication. For very large bond issues, such as a public offering, the bond trustee will usually have latitude to exercise discretion, particularly in the context of a bankruptcy case where the management must be done in relatively

short deadlines. The bond indenture consent requirements are also usually more flexible where it is anticipated that the bondholders will be geographically dispersed and hold relatively small amounts. In smaller bond issues, or where the bonds were issued to sophisticated investors who want more active control, there are often provisions that require unanimous consent of the bondholders for the trustee to take action, which can be time-consuming and impractical in an out-of-court restructuring context if the bonds are widely held.

It is advisable, therefore, to be well versed in the consent requirements under a trust indenture before attempting a workout or restructuring. Even in cases where consent percentage requirements are onerous, there can be exceptions that make it possible to creatively structure around the requirements. For example, it can sometimes be possible to increase the number of bonds issued if the statutory requirements are met, so that you can style a restructuring as a "reaffirmation" or "reissue" of the existing bonds.

In cases where onerous consent requirements are unavoidable, filing for bankruptcy protection can sometimes alleviate the strictness of the requirements. For example, if a trust indenture requires a 100 percent vote of the bondholders to alter provisions of the loan agreement, you may be able to alter the repayment provisions through a bankruptcy plan instead. By filing for bankruptcy protection, the debtor may be able to utilize the (comparatively) less-strict consent requirements of the Code. Generally, when a debtor files a plan or negotiates a pre-packaged bankruptcy, the individual bondholders are entitled to vote on the plan, though in some cases, depending on the trust indenture, the bond trustee may be able to vote on behalf of the entire class. Where individual bondholders are required to vote, their votes are counted in accordance with the voting provisions of the Bankruptcy Code, which provides that a class of claims has accepted a plan if creditors holding at least two-thirds of the dollar amount of claims voting and more than one-half in the number of claims voting vote to accept the plan. Where the trust indenture would require a 100 percent vote, the bankruptcy allows the restructuring to move forward at the lower two-thirds/one-half consent threshold.

# Bankruptcy-Specific Considerations

While a bankruptcy filing may allow for the implementation of a restructuring of the bond debt, there are additional considerations that must be addressed when filing a bankruptcy case for a nonprofit entity. First, the Code contains special provisions related to filing a nonprofit entity. The attorney general will be involved to supervise the state's interest in the nonprofit entity, which introduces another constituency with whom you must negotiate to ensure success. Moreover, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 requires that any sale or transfer of assets of a nonprofit entity pursuant to § 363 or a plan must comply with applicable nonbankruptcy law governing the transfer of property by nonprofits.

A filing can exacerbate control issues between the bond trustee and bondholders. The bondholders will likely have an opportunity to participate directly in the bankruptcy case. The Code provides for appointment of an official committee of unsecured creditors to represent the interests of unsecured creditors. If the bondholders are unsecured, they can potentially serve on this committee. For secured bondholders, the Code provides that additional committees such as a bondholders' committee may be formed with the permission of the court. If a bondholder committee is formed, there will be yet another constituency with which to negotiate and coordinate a sale or restructuring.

Finally, and perhaps most importantly, filing for bankruptcy does not negate the use limitations on the bond proceeds that are found in the trust indenture, and the risk of losing tax-exempt status will remain. If a debtor wishes to maintain the bond's tax-exempt status, there will be a restricted universe of potential buyers to which a health care facility can be sold and limited uses for the bond proceeds.

Additionally, issues can arise with respect to financing the bankruptcy case. When health care facilities are funded solely by bond proceeds, they have no logical source of funding (such as a bank or other secured lender) to finance the bankruptcy case. The bond proceeds may lose their tax-exempt status if they are used in violation of the trust indenture, and federal and state laws. The indenture trustee may hold certain funds under the bond inden-

72 December/January 2011 ABI Journal

ture, and these monies may represent a source of funding for the case. However, it is extremely important to understand the limitations on these funds before attempting to access them as a source of financing for a debtor in possession in order to avoid jeopardizing the bond's tax-exempt status.

## Additional Challenges

Whether financed by tax-exempt bonds or not, an additional issue that arises in the context of restructuring a nonprofit health care entity is the role of the board of directors. Because nonprofit entities are created under state law for a specific charitable or public mission, the nonprofit entity's board does not have the same profit-driven motive as a traditional board. The obligation of the nonprofit board is not to their shareholders (who are nonexistent), but, rather to the fulfillment of the organi-

zation's mission. For health care facilities, these missions tend to focus on providing quality care and expanding service to a broad group of people. The states, and particularly each state's attorney general, take an interest in the nonprofit's operations and transactions.

Nonprofit boards are also subject to the same state law fiduciary duties as the directors of for-profit corporations. These duties include the traditional duties of good faith, loyalty and care. As with for-profit directors, the business-judgment rule provides shelter for many decisions of nonprofit boards. However, the issue becomes murky when a nonprofit health care entity approaches insolvency. In some jurisdictions, in these circumstances a director's duties expand to creditors of the entity. With a nonprofit board, this duty to creditors is often in conflict with

its duty to the charitable mission of its health care facility. Accordingly, courts have suggested that with support from state attorney generals, traditional financial- and creditor-driven concerns should be balanced against the interest of preserving the charitable mission.

## **Conclusion**

Restructuring a nonprofit health care facility requires a well-thought-out and well-researched plan of attack, particularly where the facility is funded by tax-exempt bonds. Use limitations, consent requirements and nonprofit mission allegiance are just some of the issues that may have to be addressed in the course of the bankruptcy or workout. Success depends on a well-informed team of experts, a cohesive strategy and careful planning on the front end of any restructuring.

Copyright 2010 American Bankruptcy Institute. Please contact ABI at (703) 739-0800 for reprint permission.

ABI Journal December/January 2011 73