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Intensive Care

By Kristina Wesch

The Impact of Antitrust Regulations on Stalking-Horse Bids

Statistics show that hospitals face limited prospects of success after seeking bankruptcy protection.[1] On Dec. 17, 2013, St. Francis Hospital[2] in Poughkeepsie, N.Y., became the last of approximately a dozen hospitals in the U.S. to file for bankruptcy in 2013.[3]

On the day of its bankruptcy filing, St. Francis appeared to be no exception to the rule. With an exit strategy that involved a quick § 363 sale of substantially all of its assets to its only regional competitor, a near-complete shutdown of existing operations and a clinical realignment of St. Francis's medical services into the proposed purchaser's existing hospital campus, St. Francis faced a bleak future. Although an auction process was implemented, applicable antitrust regulations caused an unforeseen and severe impediment to competitive bidding, yet St. Francis's management, the case professionals and the agencies charged with enforcing antitrust regulations overcame the obstacles to an effective sale process and averted the crisis. On May 9, 2014, St. Francis opened its doors as MidHudson Regional Hospital of Westchester Medical Center under a business plan that not only preserved all of its previously existing services on-site, but also set out plans for expansion in the near future.

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The Filing and Stalking-Horse Bidder

St. Francis was founded in 1914, and its chapter 11 filing fell just days shy of its 100th anniversary. As of the date of its bankruptcy filing, St. Francis held 333 licensed beds and provided a wide array of medical services to the Dutchess County, N.Y., community, such as emergency treatment (including a Level II trauma center), mental health and addiction services, robotic surgery, physical and occupational therapy, cancer treatment and home care.

In 2012, St. Francis employed more than 2,000 people and serviced more than 225,000 inpatient, outpatient and emergency room visits. The hospital attributed its chapter 11 filing to the failed implementation of a new comprehensive information system that was intended to increase its operational efficiency. According to the hospital, the failure of the system had a significant impact on its financial reporting and revenue cycle functions, and as a result, the hospital was unable to meet its financial obligations.

In response to its deteriorating financial situation, St. Francis, with the help of its advisors, prepared for a chapter 11 filing and simultaneously engaged in a pre-petition marketing effort to procure a purchaser for the hospital. This effort yielded one acquisition offer: from the hospital's only local competitor, which operates its main campus just two miles away from St. Francis.

Ordinarily, the geographic proximity of the potential acquirer, combined with the lack of other competition in the region, would cause an immediate antitrust concern with both the Federal Trade Commission (FTC) and the New York State Office of the Attorney General (collectively, the "regulators"). Section 7 of the Clayton Act prohibits a merger or acquisition where the effect of the transaction "may be substantially to lessen competition,

1 *See, e.g.*, Amy Yarbrough Landry and Robert J. Landry III, "Factors Associated with Hospital Bankruptcies: A Political and Economic Framework," *Journal of Healthcare Management* (July/August 2009), Vol. 54, Issue 4, p. 252, *available at* http://biomed-search.com/article/Factors-associated-with-hospital-bankruptcies/204857945.html (last visited June 27, 2014). Research indicates that 67 percent of hospitals that filed for bankruptcy protection between 2000 and 2006 eventually ceased operations.

2 *In re St. Francis' Hospital Poughkeepsie, New York, et al.*, Case No. 13-37725 (Bankr. S.D.N.Y.). Farrell Fritz PC represented Westchester County Health Care Corp. in its acquisition of St. Francis. The views expressed herein are solely those of the author and do not represent the views of Westchester County Health Care Corp. or any other party in this case.

3 *See* Bob Herman, "10 Hospitals that Filed for Bankruptcy in 2013," *Becker's Hospital CFO* (Dec. 20, 2013), *available at* www.beckershospitalreview.com/finance/hospitals-that-filed-for-bankruptcy-in-2013.html; "11 Hospitals that Filed for Bankruptcy in 2013," *Value Healthcare Services* (2014), *available at* http://valuehealthcareservices.com/education/11-hospitals-that-filed-for-bankruptcy-in-2013/ (last visited June 27, 2014).

or to tend to create a monopoly."[4] It is routinely applied to nonprofit hospital mergers and acquisitions.

However, in this situation, the proposed acquisition would have fallen under the "failing-business defense" to this prohibition. The rationale behind the failing-business defense is that it is better to keep capacity in the market, even if such capacity is monopolistic, than to have the capacity leave the market altogether.[5] Absent the sale, St. Francis would have been unable to meet its financial obligations, would otherwise have been unable to successfully reorganize its financial affairs and would have been forced to shut down.[6] The proposed acquisition was thereby excepted from the review of the regulators, who acknowledged in writing the applicability of the defense in these circumstances,[7] and the bidder became the stalking-horse bidder in the *St. Francis* bankruptcy case.

The Auction Conundrum

Pursuant to the court order, a sale timeline was set and an auction was scheduled. However, as the bid deadline approached, it became apparent that the only qualified bid that St. Francis would receive, aside from the stalking-horse bid, would come from Westchester County Health Care Corp. (WCHCC), an advanced medical care hospital in Valhalla, N.Y. By virtue of the submission of another offer for the purchase of the St. Francis assets, the stalking horse's offer would no longer be the only viable alternative to St. Francis exiting the health care market.[8] Therefore, the failing-business doctrine would no longer apply to the stalking-horse transaction, subjecting the stalking horse's proposed acquisition of St. Francis to a comprehensive antitrust review.[9]

Considering the two-mile distance between the hospital systems and the lack of medical options that would exist in the community upon an acquisition, regulatory approval seemed unlikely at best. Therefore, the anticipated receipt of just one additional qualified bid catapulted St. Francis and the case professionals into a gray area where the stalking horse was technically a qualified bidder entitled to participate in the auction, but would more than likely never be able to close on the transaction.

As is customary in a bankruptcy auction, the sale procedures order provided that at the conclusion of the bidding, St. Francis would confer with its advisors and certain other constituencies in the case and announce on the record what bid was deemed to be the "highest or best" bid. As disclosed by St. Francis in its related pleadings, it quickly became evident to all of the case professionals that, in light of the regulatory issues and substantial closing risks associated with a transaction involving the stalking horse, the stalking horse's bid could not, under the business judgment of St. Francis, constitute a "better" offer than that of WCHCC, regardless of economic value. In fact, WCHCC eventually informed St. Francis that had the auction proceeded, it intended to submit an offer identical to that of the stalking horse with consideration exceeding the stalking horse's bid only by the minimum overbid required by the sale procedures order and not offer any additional consideration or participate in any further rounds of bidding. St. Francis was now faced with a conundrum: Move forward with an auction in which the stalking-horse bidder could, in all likelihood, never close or approach WCHCC, the only remaining viable (as opposed to qualified) bidder, or cancel the auction in order to engage in arm's-length sale negotiations in which the stalking-horse bid would be used as a baseline, despite the lack of authority in the sale order to do so.

After discussions with the creditors' committee, other constituencies in the case and the Office of the U.S. Trustee, St. Francis ultimately chose the latter route. The stalking horse also recognized the regulatory hurdles to its acquisition of the hospital and entered into a stipulation with St. Francis whereby it stipulated its willingness to abide by the hospital's decision to cancel the auction and formally terminated its purchase offer. As a result of arm's-length negotiations, WCHCC and St. Francis negotiated a sale that provided economic consideration of approximately $19 million more than the stalking-horse bid, as well as many other superior noneconomic terms.

Fiduciary Considerations

In making the decision to cancel the auction, three considerations dominated: (1) the fiduciary obligations of the *St. Francis* bankruptcy estate and its professionals, (2) St. Francis's business judgment discretion in determining a "highest and best" offer, and (3) the ordinarily reactive nature of the regulators. As disclosed to the court in pleadings that were related to the sale, the professionals recognized that WCHCC's strategy of offering only the minimum overbid under the sale procedures order would have a "devastating impact on the Debtors' estates," and that in light of the uncertainty of the stalking horse's ability to close, there could be "no viable auction process." In short, by submitting to an auction structure whereby a willing, able and qualified bidder could constrain the estates to a depressed fire sale price for the assets, the estates and their professionals may have been perceived as falling short of meeting their fiduciary duties. St. Francis determined, based on its business judgment, that a negotiated sale with WCHCC would yield the most profitable outcome for the *St. Francis* bankruptcy case.

The biggest consideration in the process was the normally reactive nature of the regulators' review and decision-making, and their willingness in this case to provide proactive insight on the consequences of selecting the stalking horse

4 15 U.S.C. § 18.

5 *See* Lauren N. Norris, "The Failing Firm Defense," American Bar Association Young Lawyers Division, *The 101 Practice Series: Breaking Down the Basics* (2010), *available at* www.americanbar.org/groups/young_lawyers/publications/the_101_201_practice_series/failingfirm.html (quoting Federal Trade Commission and U.S. Department of Justice's Horizontal Merger Guidelines § 5 (the "Merger Guidelines") ("[A] merger is not likely to create or enhance market power or to facilitate its exercise, if imminent failure ... of one of the merging firms would cause the assets of that firm to exit the relevant market.")).

6 To invoke the failing-business defense, four criteria must be met: (1) the allegedly failing firm would be unable to meet its financial obligations in the near future; (2) it would not be able to reorganize successfully under chapter 11; (3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition of its assets that would both keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger; and (4) absent the acquisition, the assets of the failing firm would exit the relevant market. Merger Guidelines § 5.1.

7 *See* Debtors' (I) Notice of Cancellation of Auction and (II) Supplement to Motion for Order (A) Authorizing the Sale of Substantially All of the Debtors' Assets Free and Clear of All Liens, Claims, Encumbrances, and Other Interests; (B) Authorizing the Assumption and Assignment of Certain Executory Contracts; and (C) Granting Other Related Relief (the "Supplemental Motion"), Exhibit D (letters from the regulators, dated Dec. 17, 2013, acknowledging the applicability of the failing-business doctrine), *In re St. Francis' Hospital Poughkeepsie, New York, et al.*, Case No. 13-37725 (Bankr. S.D.N.Y.) [Dkt. No. 271].

8 Any offer above liquidation value constitutes a viable "alternative offer" for purposes of regulatory review. Merger Guidelines § 5.1 n.39.

9 The failing-business defense is considered to be the weakest argument for defeating an antitrust violation. It is only successful in very rare cases, whereby the firm's market share would be reduced to such a level that would undermine the government's argument that the merger is anticompetitive. *ProMedica Health Systems Inc. v. Federal Trade Commission*, 749 F.3d 559 at 572 (6th Cir. 2014).

as the winning bidder at a live auction.[10] Regulators typically do not issue advisory opinions or even statements regarding potential transactions, but will instead conduct an investigation concerning a committed or even a closed transaction and, upon finding a violation, will order it to be unwound.[11] In this case, an open and ongoing dialogue between the St. Francis professionals and the regulators led to the submission by the FTC of a letter expressing concern about the stalking horse's ability to receive regulatory approval in light of WCHCC's bid.[12] The potential prohibition or unwinding of any transaction with the stalking horse was vital to St. Francis's appreciation of the significant risks that were associated with the stalking-horse bid. It was the regulators' decision to break from custom and provide the case professionals with this insight, which ultimately led to the success of the sale process and yielded a consideration that was nearly double the offer presented by the stalking horse.

Conclusion

The § 363 sale process is intended to maximize value to a debtor's estate through a competitive bidding process. To that end, it is designed with flexibility in mind and leaves considerable discretion to the debtor and its professionals in formulating and administering the sale process. It is this flexibility and the statute's deference to the business judgment of the debtor that allowed the case professionals to respond with a creative approach when applicable antitrust regulations threatened to chill the sale process. In this case, on account of a collaborative process among the bidders, the case professionals and the regulators, the outcome of the *St. Francis* bankruptcy case far exceeded expectations for both the creditors and the community served by the hospital. abi

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10 Under the Hart-Scott-Rodino Improvements Act, a transaction falling above a threshold value is required to file a pre-merger/pre-acquisition notice with the FTC and give the FTC an opportunity evaluate the proposed transaction; however, the threshold is high, making many health care transactions such as the St. Francis transaction ineligible. *See* 15 U.S.C. § 18a.

11 A current and significant example is the recent ruling of the U.S. District Court for the District of Idaho, permanently enjoining and ordering the unwinding of the acquisition of Idaho's largest physician group by St. Luke's Health System, an Idaho-based nonprofit health system. *See Saint Alphonsus Medical Center-Nampa Inc. v. St. Luke's Health System Ltd.*, 2014 WL 407446 (D. Idaho 2014). St. Luke's and the physician group that it acquired have appealed the district court's decision to the U.S. Court of Appeals for the Ninth Circuit and on June 12, 2014, filed its brief in support of appeal. *See* Case No. 14-35173 (9th Cir.) [Dkt. No. 20]. Similarly, in April 2014, the U.S. Court of Appeals for the Sixth Circuit affirmed a ruling ordering the unwinding of Toledo, Ohio-based ProMedica to divest Maumee, Ohio-based St. Luke's Hospital on the basis of competition violations. *See Promedica Health System Inc. v. Federal Trade Commission*, 749 F.3d 559 (6th Cir. 2014).

12 *See* Supplemental Motion, Exhibit E.