



# COVID-19: LIQUIDITY AND MUNICIPAL BOND CONSIDERATIONS FOR HOSPITALS

**ROPES & GRAY**

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# AGENDA

- **Liquidity Concerns**
- **Federal CARES Act Relief**
- **Planning for and Living with Covenant Default**
- **Disclosure Considerations**

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# Liquidity concerns

- Federal Reserve intervention in municipal market
  - Backstopping the muni bond market through the Money Market Mutual Fund Liquidity Facility
- Status of the municipal market today for hospital borrowers
  - Tax-Exempt: Still dysfunctional; but new issuances beginning to reemerge after multi-week shutdown
  - Taxable: High-grade credits able to access public market; but all at significant concessions
- Other sources of liquidity
  - Bank lines and other loans
  - Tapping endowments (living donor consent or UPMIFA)
    - Be aware of charitable asset restrictions that require AG/court approval to access use restricted funds
    - May be possible to take a “loan” from endowment to increase liquidity/avoid default

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# CARES Act

- On March 27, the President signed the Coronavirus Aid, Relief and Economic Security Act or CARES Act
- The CARES Act includes numerous provisions intended to provide relief to hospitals and healthcare providers, including:
  - **Public Health and Social Services Emergency Fund:** Provides for approximately \$130 billion in funding to prevent, prepare for, and respond to COVID-19, including \$100 billion to reimburse eligible health care providers (including all Medicare or Medicaid enrolled suppliers and providers) for health care related expenses or lost revenues attributable to COVID-19
    - Must be non-reimbursable from other sources/payors
    - Intended uses include building temporary structures, leasing properties, purchasing medical supplies and equipment (including PPE and testing supplies), increasing workforce, operating emergency centers, retrofitting facilities and adding surge capacity
    - Recipients must apply for payments, submit reports and maintain documentation as determined by HHS

# CARES Act

- ***Expansion of the Medicare Hospital Accelerated Payment Program*** (as supplemented by CMS on March 28): Temporarily expands the existing Medicare accelerated payment program to permit all Medicare providers to obtain advance or accelerated Medicare payments during the COVID-19 emergency.
- ***Federal Reserve Lending Programs and Facilities***: Provides \$454 billion for senior loans, guarantees and other investments in programs or credit facilities established in support of the Federal Reserve’s lending system to eligible businesses, states and municipalities.
- ***Medicare Payment Relief***: Temporarily suspends Medicare sequestration cuts between May 1, 2020 and December 31, 2020; provides relief to hospitals by increasing the weighting factor for each diagnosis-related group under the Medicare inpatient prospective payment system by 20% for discharges during the emergency period with a primary or secondary diagnosis of COVID-19.
- ***Small Business Administration Paycheck Protection and Economic Injury Disaster Loans***: Appropriates \$360 billion in loans in \$10 million and \$2 million maximum buckets to nonprofits for use to make payroll and refinance debt, but of limited use to hospitals and affiliated provider entities as the recipient entity must have 500 or less employees, taking into account employees of all direct and indirect affiliates.

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# Potential Causes of a Default

- Reduction in revenues from cancellation of elective procedures, shift to treatment of uninsured/underinsured populations
- Increased expenses to handle capacity surge and consumption of PPE supplies
- Closed or restricted credit markets: increased costs of short-term financing
- Declines in endowment returns
- Shortfalls in charitable fundraising
- Industry-wide downgrades
- ***Note critical distinction between technical defaults and payment defaults***
  - Failure to meet financial covenants vs. non-payment of debt service

# Financial Covenants

- Nearly all hospital borrowers have some form of debt service coverage ratio (DSCR)
  - Typical DSCR is 1.20x-1.10x; DSCR below triggers a “soft default”
  - “Soft default” requires consultant call; some MTI’s don’t require consultant call until two consecutive years of failed DSCR
  - Usually tested once at the end of fiscal year; private debt document covenants may require more frequent testing
  - Many borrowers have a “hard default” below 1.00x; this triggers a technical Event of Default with no opportunity for consultant call cure
- Some borrowers have other financial covenants, e.g., days cash on hand
  - Similarly structured with soft and hard defaults
- Event of Default gives rise to theoretical possibility of debt acceleration; acceleration **unlikely to occur** in current environment
- Be aware of more stringent private placement covenants and associated “cross-defaults”

# Avoiding a Covenant Default and a Note About GAAP Changes

- Avoiding a Financial Covenant Default:
  - Add a money-making affiliate to the obligated group
  - Borrow from endowment (typically for DCOH test)
- “Pick your Poison”: Most Master Trust Indentures have an “interpretation” provision that allows the borrower to use old or new GAAP
  - Provision usually found in the first section of the MTI, immediately following the definitions
  - Recent GAAP changes include updates to net asset classes (from three to two) and changes to lease classifications
- Read MTI definitions and GAAP interpretation provision closely to determine whether unrealized investment losses should be factored into DSCR calculations
  - Typical definition excludes unrealized losses/gains

# Waivers of Defaults

- Private lenders may grant waivers of defaults or potential defaults under private loan documents
- Such waivers may be essential to avoid a technical cross-default under borrower's MTI or other debt
- If borrower has sufficient debt held by private banks (typically 25% or 50%), banks may be able to direct the Master Trustee to waive master indenture financial covenant default (varies by master indenture)

# Potential Consequences of a Covenant Default

- Remedies available to lenders, though unlikely to be used:
  - Acceleration of indebtedness by creditors
  - Exercise by creditors of contractual remedies/foreclosure
  - Appointment of a receiver under state law
- More likely outcome of a financial covenant “hard default”:
  - Call in a consultant to review operations/finances in unless a majority of bondholders say it’s not required
  - No immediate acceleration
  - Qualified audit report
  - Rating agency actions because of results and qualified audit
  - Bad press and vendor relations issues
  - For those who have restricted endowments, consider a decap with or without AG to clear 1.0 if accounting works under your MTI – may only solve DCOH not DSCR issues

# Potential Secondary Consequences of a Default

- Inability to issue additional debt due to inability to pass tests for new debt
- Difficulty with vendors
- Difficulty in renewing insurance coverage or rate increases
- For health care providers conducting federal grants research, inability to file complete A-133 research report
- Enhanced scrutiny following federal and state filings (e.g., IRS form 990, state PC)
- **BUT – nearly every hospital and health system will be in the same boat; none of these are necessarily insurmountable**

## Remedies Not Available to Creditors

- Charitable corporations cannot be forced into involuntary bankruptcy
- Courts are reluctant to grant remedies that would interfere with operations and put health and safety at risk, especially during a public health crisis
- Health care facilities often are special purpose facilities suitable only for one use. Licensing requirements impose limitations on who can operate the facility

# Duties of Directors of Nonprofits in Default Situations

## Directors' Fiduciary Obligations

- Directors' fiduciary obligations are to pursue charitable mission
  - Be informed and attentive; act independently; rely, within reason, on management and experts
  - In insolvency or “zone of insolvency” (if applicable under state law), duties are heightened
- Directors can fulfill their duties to the charitable mission and enterprise in default situations, with the defaults remaining uncured
  - The directors must exercise their business judgment with respect to the default
  - Clear documentation is advisable

# Strategies For Living With Default – Develop the Business Plan

- Obtain reliable cash flow analyses
- Determine what the business can afford and what it cannot afford
  - Preserve essential cash
- Prioritize payment of payables to avoid incurrence of personal liability to third parties
- Preserve key supplier relationships, contracts, and personnel
- Review the adequacy of all insurance coverage, including D&O Insurance

# Strategies for Living with Default – Review and Address Motivations of Other Players

- Players' Motivations in Not-For-Profit Context
  - **Bond Insurers:** Avoid having to make any payment on the bonds
    - Foreclosure would be problematic
  - **Muni-bond funds:** Maintain valuations, liquidity
    - Foreclosure would be problematic
  - **Bond Traders:** Make a profit on the trade
  - **Swap Counterparties:** Continue to receive current income; maintain hedges; avoid write-downs
    - Issues on swaps and posting collateral for swaps
    - Counterparty risk in posting collateral for swaps
  - **Trade Creditors:** Retain the hospital as a customer; collect receivables
- Be prepared for possible intervention by State AG

# Strategies for Living with Default – Take the Lead in Developing Solutions

- Stop financial losses
  - Escalate cost-cutting
  - Sell or divest non-performing assets
- Propose waivers, changes in covenants, and other needed concessions
- Should an outside consultant be retained?
  - Take control of the process

## Strategies for Living with Default – Maintain a Strong Adversarial Posture When Needed

- Be wary of incremental concessions
- Major concessions and restructuring should occur in the context of a viable exit strategy
- Remember that the third party often has as much at risk as you do

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# Voluntary Market Disclosures

- **No duty or obligation** to provide the market with **voluntary statements** about the impact of the COVID-19 crisis outside of normal disclosure periods except:
  - Statutory duty (not applicable to unregistered debt)
  - Correct a material statement that was incorrect when made
  - Correct a forward-looking statement (where a duty to update was not disclaimed)
  - Disclose or abstain from trading
- A note about **forward-looking projections** in any disclosures:
  - Specific disclaimer that such disclosure is forward-looking and the borrower is under no duty to update
  - Disclosure is made in good faith and is reasonable based on the facts known at the time it was made
  - Make your projections in RANGES as opposed to specific predictions
  - Include assumptions upon which such projections are based

# Inquiries from Investors and Rating Agencies

- **Inquiries from Investors** – Provide public information; refer them to organization’s public COVID-19 webpage, and note that you expect to provide an update in your next quarterly/annual disclosure
- **Inquiries from Rating Agencies** – Respond as appropriate to questions asked; there is generally no need to provide exhaustive projections

# EMMA Disclosures

- Quarterly and Annual Reports
  - Enhanced disclosure of current COVID-19 impact is likely warranted
  - For most health systems/hospitals, COVID-19 **WILL** have a material adverse impact (instead of “may”)
  - Forward-looking projections are not required; however, there is no-one-size-fits-all answer; each borrower needs to assess and reassess its financial position and the facts on the ground at the time the disclosure is being made
- A borrower subject to the new Rule 15c2-12 amendments (i.e., has issued tax-exempt debt since February 27, 2019) **must disclose** the incurrence of material financial obligations and waivers, amendments or defaults that evidence financial difficulties via EMMA
  - Rating changes and material technical defaults related to public, tax-exempt debt must always be disclosed (regardless of last issuance date)

# New Public Offerings and Private Placements

- New public offerings
  - Detailed risk factor relating to COVID-19 should be included
  - Same advice with respect to forward-looking statements as previously noted
- Private placement disclosures
  - Disclosing detailed projections to a private lender may create an obligation to provide same information to the market
  - Attempt to provide private lenders with information that is already in public (e.g., on your website or reported to the state)
  - If appropriate, seek assurance from lender that no information provided to commercial bank may be used for trading purposes



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Send questions to [COVID-19-Implications@ropesgray.com](mailto:COVID-19-Implications@ropesgray.com)

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