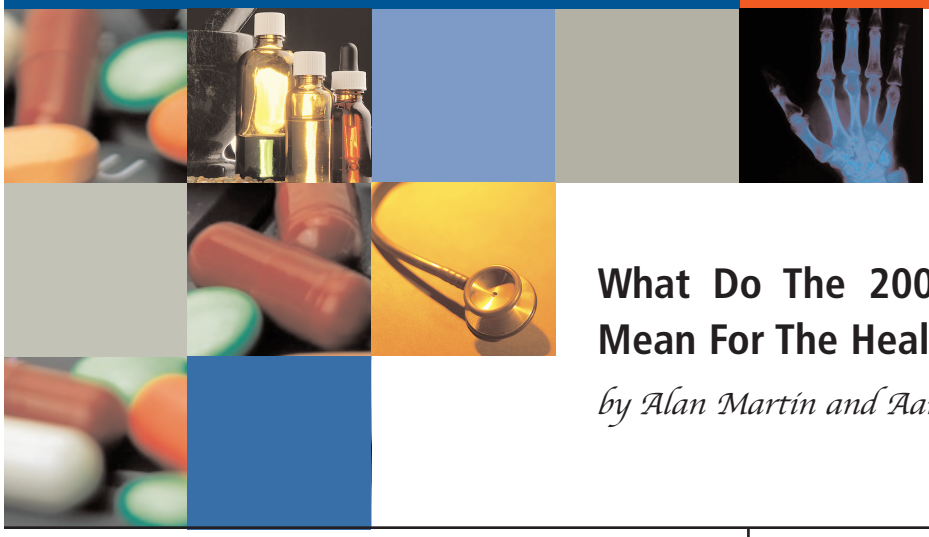


What Do The 2005 Bankruptcy Amendments Mean For The Healthcare Industry?

by Alan Martin and Aaron Malo

As has been widely reported in the financial press, the April 2005 amendment of the Bankruptcy Code represents the most sweeping changes to the Code in several decades. And while considerable media coverage has described what the new laws mean for consumers, the ramifications of those changes for healthcare bankruptcies has gone largely unaddressed by the mainstream press. We believe that for the healthcare industry, the most significant ramifications of the 2005 bankruptcy law changes are likely to include the following:

The Creation of a New Category of Bankruptcy Filings - Healthcare Business Bankruptcies

Anyone involved with the healthcare industry can tell you that it's unique. From the innumerable agencies and organizations that regulate it, to its unique construct where patient care often trumps economic reality, to the universe of highly specialized professionals that work within it, the healthcare industry is fundamentally different from all other industries. The new law recognizes a new type of debtor – the "healthcare business" organization – to which special rules and regulations will apply. Under the Code, healthcare businesses will include "any public or private entity (without regard to whether that entity is organized for-profit or not-for-profit) that is primarily engaged in offering to the general public facilities and services for (i) the diagnosis or treatment of injury, deformity, or disease; and (ii) surgical, drug treatment, psychiatric, or obstetric care." Such healthcare businesses include, but are not limited to general or specialized hospitals, ancillary ambulatory, emergency, or surgical treatment facilities, hospices, home health agencies, long-term care facilities, homes for the aged, domiciliary care facilities, and a host of other "related" businesses. We believe that over time, the universe of "healthcare businesses" may well expand to include pharmacies, imaging centers, and even medical equipment lessors.

Appointment of a Patient Care Ombudsperson in All Healthcare Business Cases

The Code has been amended to include a new Section 333 which provides that, a "patient care ombudsperson" must be appointed in all chapter 7, 9, or 11 cases where the debtor is deemed to be a healthcare business "unless the court finds that the appointment of such ombudsperson is not necessary for the protection of patients under the specific facts of the case." Under the new law, the patient care ombudsperson is required to monitor the quality of patient care provided to patients of the debtor, interview patients and physicians, report to the court regarding the quality of patient care provided to patients, and inform the court immediately of any issues

materially and adversely affecting patient care. Though the Code is silent on this point, it seems virtually certain that the costs incurred by a patient care ombudsperson will be entitled to administrative priority, which means that they will need to be paid, in full, before any funds can "trickle down" to general unsecured creditors. Moreover, it seems exceedingly likely that certain decisions that were considered to be solidly within the discretion of the debtor's business judgment, may now be subjected to scrutiny by the patient care ombudsperson. Such decisions might well include the rejection of certain equipment leases, the closure of certain practice areas, and even the termination of certain employees. While the full scope of the power and influence patient care ombudspersons will have on healthcare bankruptcy cases has yet to be determined, it would be naïve to think that their impact will be minimal.

Mandatory Procedure for the Disposition of Patient Records

The Code has been amended to include a new Section 351 which provides that, if a healthcare business commences a case under chapter 7, 9, or 11, "and the trustee does not have a sufficient amount of funds to pay for the storage of patient records in the manner required under applicable Federal or State law," a new procedure must be strictly followed. Specifically, the trustee/ombudsperson for such case must: (1) promptly publish notice that if patient records are not claimed by the patient or an insurance provider by a specified date at least one year after issuance of the notice, those patient records will be destroyed; (2) diligently attempt to notify "directly" each patient for whom the debtor maintains patient records and their appropriate insurance carrier at the most recent known address of that patient, or a family member or contact person for that patient during the first 180 days of the required one-year period; (3) notify, by certified mail, at the end of the specified 365-day period, each appropriate Federal agency requesting permission from that agency to deposit unclaimed patient records with that agency; and (4) destroy all unclaimed patient records by shredding or burning if the records are written, or mutilating those records "so that those records cannot be retrieved if the records are "magnetic, optical, or other electronic records." The costs associated with notifying patients, contacting government agencies, and disposing of patient records are potentially enormous for large healthcare institutions. Further, Section 503(a)(8) specifically affords these costs administrative priority status. As such, these new statutory provisions are likely to have significant economic impact on healthcare bankruptcy cases.

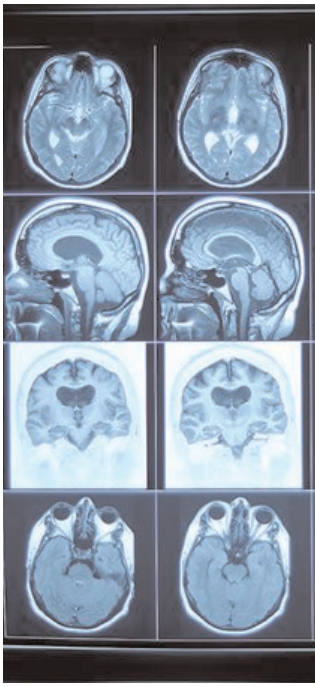
Mandatory Procedure for Transferring Patients

The Code has been amended to include a new Section 704(a)(12) requiring the trustee to "use all reasonable and best efforts to transfer patients from a healthcare business that is in the process of being closed to an appropriate healthcare business." The Code provides a statutory definition for such "appropriate healthcare business," and requires that such transfers involve

consideration of patient care. This procedure may prove to be very costly. And under new Section 503(a)(8), all of the costs associated with statutorily required patient transfers will be afforded administrative priority status. As such, this new statutory provision is likely to have significant effects on the economics of healthcare bankruptcy cases.

Automatic Stay Modified to Allow Federal Government Maximum Flexibility in Healthcare Business Bankruptcy Cases

For many healthcare institutions, participation in Medicare and other federal health programs is the lifeblood of the organization. As such, healthcare bankruptcies have historically been replete with legal battles over whether the government could simply "turn off the tap" to federal funds when financially troubled healthcare businesses filed for bankruptcy. The new amendments amend Section 362 to specifically exempt from the automatic stay any action taken by the federal government to exclude the debtor from participation in Medicare and any other federal healthcare program. This change is of potentially massive importance to healthcare businesses as it provides the Centers for Medicare and Medicaid Services ("CMS") huge amounts of leverage over healthcare business debtors. Subject only to its own guidelines, policies, and procedures, CMS may now exclude any healthcare business from federally funded programs. The converse of that is CMS may now impose whatever conditions it deems to be appropriate upon any healthcare business debtor that wishes to participate in such programs. This is likely to make CMS a powerful "player" in virtually all significant healthcare business bankruptcy cases.



Obviously, these pages cannot address the entirety of all the changes likely to affect healthcare bankruptcy cases. But as this short paper explains, the 2005 bankruptcy law changes are potentially very significant for the healthcare industry. Sheppard, Mullin bankruptcy professionals are at the forefront of all aspects of the healthcare industry, and are ready to discuss the new law changes with you.

For more information about our bankruptcy or healthcare practices, please contact:

Alan Martin
714.424.2831
amartin@sheppardmullin.com

Aaron Malo
714.424.8223
amalo@sheppardmullin.com

LOS ANGELES

333 South Hope Street, 48th Floor
Los Angeles, California 90071
213.620.1780 | Fax: 213.620.1398

CENTURY CITY

1901 Avenue of the Stars, Suite 1600
Los Angeles, California 90067
310.228.3700 | Fax: 310.228.3701

SAN FRANCISCO

Four Embarcadero Center, 17th Floor
San Francisco, California 94111
415.434.9100 | Fax: 415.434.3947

ORANGE COUNTY

650 Town Center Drive, 4th Floor
Costa Mesa, California 92626
714.513.5100 | Fax: 714.513.5130

DEL MAR HEIGHTS

12544 High Bluff Drive, Suite 300
San Diego, California 92130
858.720.8900 | Fax: 858.509.3691

SAN DIEGO

501 West Broadway, 19th Floor
San Diego, California 92101
619.338.6500 | Fax: 619.234.3815

SANTA BARBARA

800 Anacapa Street
Santa Barbara, California 93101
805.568.1151 | Fax: 805.568.1955

NEW YORK

30 Rockefeller Plaza, 24th Floor
New York, New York 10112
212.332.3800 | Fax: 212.332.3888

WASHINGTON, D.C.

1300 I Street, NW, 11th Floor East
Washington, DC 20005
202.218.0000 | Fax: 202.218.0020

SHEPPARD MULLIN

SHEPPARD MULLIN RICHTER & HAMPTON LLP

ATTORNEYS AT LAW

www.sheppardmullin.com