Hot Opportunities in a Cooling Economy: Buying Struggling Facilities at Distress Sales[1]

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Successful acquisitions come in many shapes and sizes. For the senior living company looking to expand its portfolio, distress sales can provide a unique opportunity to purchase the diamond-in-the-rough at a very favorable price.

What are the typical ways to acquire a distressed facility? Let's take the example of a skilled nursing facility (the SNF) that is in default on $10 million of secured bank debt. A potential purchaser has several ways to try to acquire the facility for less than the full outstanding debt.

The Consensual Sale (aka the "Short Sale"). In this method, the seller and the bank agree to the purchase price with the buyer. The purchase process is almost exactly like the typical asset sale of a facility that is performing well. The differences lie in the fact that that the bank must consent to the lower price and in the risks that can arise in distress sales. For one thing, after the sale closes, it is usually impossible for the buyer to recover from the seller for any undisclosed issues that come to light after the sale (the seller won't have the money). In addition, other creditors of the seller may also try to attack the sale or pursue the buyer after the fact for successor liability. The risk of liability to other creditors is usually small, but it must be evaluated on a case-by-case basis.

The Foreclosure Sale. Another method to acquire the distressed SNF is to wait for the bank to initiate a foreclosure and then to bid at the sale. A foreclosure generally erases liens and claims of junior creditors against the SNF, so the buyer is able to get clean title to the facility and avoid some creditor claims. This is a significant advantage of foreclosures compared to consensual sales. A disadvantage of foreclosures, however, is the difficulty of getting contracts assigned to the buyer, such as vendor contracts, operating licenses, and Medicare/Medicaid provider agreements (ongoing contracts). These usually cannot be sold to the buyer without the consent of the other party to the contract (the vendor, the licensing authority, etc.), and the buyer has limited opportunity to negotiate assignments because of the short foreclosure timeline. The expedited schedule also means the buyer has the risks that can flow from limited due diligence, such as the failure to identify any major deficiencies in the building or the services. Some of these issues can be determined and pre-negotiated in advance of the foreclosure, but to the extent uncertainty remains, the risks can be figured into the buyer's pricing at the foreclosure sale.

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The Bankruptcy Auction. A third method is to try to purchase the SNF through a bankruptcy auction, if the seller or its creditors have chosen to initiate a bankruptcy filing. In bankruptcy, assets like the distressed SNF are often put up for bidding in what is known as a "363" sale (named after the governing section of the Bankruptcy Code). The seller will usually choose a specific purchaser in advance of the auction, known as the "stalking horse," with whom the seller will negotiate the sales price and asset purchase agreement. Other potential buyers then have the right to come to the auction and bid against the stalking horse. At the conclusion of the auction, the bankruptcy court enters an order approving the sale to the highest bidder, and if the stalking horse loses, it is paid a break-up fee for having set the price floor. The bankruptcy order provides additional protections that can make the sale better than other types of distress sales. Bankruptcy also allows the buyer to assume ongoing contracts the buyer, even if the other parties do not consent to assignment. Bankruptcy sale protections can be so good that sometimes buyers will require their seller to file bankruptcy and go through the "363" process as a condition to closing.

The REO Purchase. A buyer not interested in purchasing the SNF at an auction might sometimes have the opportunity to buy the SNF out of the bank's inventory later, known as "real estate owned" (abbreviated REO). If the bank puts the facility up for foreclosure and cannot obtain a satisfactory bid from a third-party, the bank will sometimes bid in its own debt (a process known as "credit bidding" that consists of setting off against the debt owed by the borrower). In this instance, the bank will become the new owner of the facility. The bank will then keep the facility in inventory and will look for buyers to purchase the facility at a favorable price. A buyer purchasing REO from the lender will engage in a sales process much like a normal asset purchase sale between private parties. Because the property has been through foreclosure, there is little concern about the claims of other creditors that have usually been erased. REO sales are uncommon for most senior living facilities though, and especially SNFs, because most lenders are unwilling to take the risks inherent in operating a healthcare facility for an interim period after buying it at the foreclosure sale.

The Loan To Own Strategy. Finally, one popular strategy in recent years is for the proposed purchaser to buy the $10 million debt from the lender, and then use this debt as leverage to get ownership of the facility. Of course, owning the debt is not the same as owning the facility, so the strategy requires additional steps. As an example, assume the buyer can purchase the $10 million loan from the lender for only $6 million (because the lender wants cash now and wants out of the loan). The buyer purchases the debt – i.e., it becomes the lender -- then notices foreclosure of the property. At foreclosure, the buyer has the right to bid up to $10 million dollars for the facility without having to come out of pocket a single dollar – it simply provides a credit against the $10 million debt it is already owed (credit-bidding). It can bid the full $10 million, despite the fact that it only paid $6 million for the loan; as a result, it gets $4 million dollars of extra buying power at no out-of-pocket cost. The strategy has risks as well, however; there could be unknown problems with enforceability of the loan, or the SNF owner might file bankruptcy. Bankruptcy may allow the SNF owner to reorganize its business instead of sell the

facility, by proposing to pay the $10 million loan over time, often at a significant discount. Litigation and bankruptcy risks should must be carefully analyzed and priced into the purchase of the lender's debt at a discount.

Conclusion: Hot Opportunities. Understanding the risks and rewards involved in a distressed acquisition is critical for seizing on the "buy" opportunities that the new market conditions are likely to create over the next few years. For the strategic buyer looking for bargain prices and willing to take calculated risks, hot opportunities can be the silver lining in the clouds that portend a cooling economy.