Chapter 3:
Health Care Providers' Eligibility for Bankruptcy

The first issue a health care provider should consider in any insolvency planning is whether it is eligible for bankruptcy protection. Section 109 of the Bankruptcy Code establishes what "person" or "entity" is eligible for relief under the various chapters of the Bankruptcy Code.

1. General Rules of Eligibility

Most entities (including corporations or partnerships) are eligible to file for bankruptcy protection under the Bankruptcy Code. Certain entities are not eligible under the statute. In the health care arena, most entities that can file under chapter 7 (liquidation) also can file under chapter 11 (reorganization). A hospital that is organized as a "municipality" and meets other criteria may file under chapter 9 (adjustment of debts for a municipality). One important limitation under § 109 of the Bankruptcy Code is that a domestic insurance company may not be a debtor under either chapter 7 or chapter 11.[90] The application of this statutory limitation in the health care arena has frequently arisen around whether health maintenance organizations (HMOs) constitute domestic insurance companies that are ineligible for bankruptcy protection. Similar questions exist as to whether other entities unique to the health care field (PHOs, POs, IDSs, etc.[91]) are insurance companies for purposes of § 109 of the Bankruptcy Code. The trend in the case law appears to be that to the extent the entity assumes "risk" (such as when they enter into capitated provider contracts), as insurance companies do, the statutory limit will apply and prevent the entity from obtaining bankruptcy protection. Whether medical trust funds are eligible for bankruptcy relief could prove to be a context in which similar principles are applied to determine eligibility.

While nonprofit health care organizations are eligible to file for voluntary relief under chapters 7 or 11, a nonprofit organization cannot be the

90 11 U.S.C. § 109(b)(2).
91 See the discussion in Section 3 of this chapter.

subject of an involuntary petition (a bankruptcy case commenced by creditors against a debtor without the debtor's permission).[92]

2. Is an HMO Eligible for Bankruptcy Protection?

Whether an HMO is a domestic insurance company has been the subject of great dispute. For example, courts applying Louisiana, Arizona, Pennsylvania, Texas and Michigan law have held that HMOs are not domestic insurance companies, and therefore are eligible for bankruptcy relief.[93] Courts applying Wisconsin, New Jersey, Illinois, New Hampshire, Georgia and Oregon law, however, have found that HMOs are domestic insurance companies, and therefore not eligible for bankruptcy relief.[94]

Interestingly, the decisions applying various states' law (including Louisiana, Arizona, Texas and Wisconsin) to the question of whether or not an HMO is a domestic insurance company take their starting point from decisions in the Bankruptcy Court and the U.S. District Court for the Central District of California, for the consolidated cases filed by Family Health Services Inc. The bankruptcy court's decision in *In re Family Health Services*[95] applied applicable state law and ruled that HMOs are not domestic insurance companies and were eligible for bankruptcy relief. Additionally, the court ruled that certain affiliates organized under the laws of various states were eligible for bankruptcy relief because neither Illinois, Indiana nor Ohio statutes would classify HMOs as domestic insurance companies. However, the bankruptcy court decision was later reversed by the U.S. District Court for the Central District of California.[96]

Most courts have agreed with the conclusion of the U.S. District Court for the Central District of California that HMOs are not eligible for bankruptcy relief. The same year as the *In re Family Health Services* decisions, a

92 11 U.S.C. § 303(a).

93 *See, e.g., In re Group Health P'ship Inc.*, 137 B.R. 593 (Bankr. E.D. Pa. 1992); *In re Michigan Master Health Plan Inc.*, 90 B.R. 274 (E.D. Mich. 1985).

94 *In re Estate of Medcare HMO*, 998 F.2d 436 (7th Cir. 1993); *In re Family Health Services Inc.*, 143 B.R. 232 (C.D. Cal. 1992); *In re Beacon Health Inc.*, 105 B.R. 178 (Bankr. D.N.H. 1989); *In re Portland Metro Health Inc.,* 15 B.R. 102 (Bankr. D. Or. 1981); *In re Master Health Plan*, No. MC 197-021, 1997 U.S. Dist. LEXIS 22880 (S.D. Ga. June 18, 1997).

95 *In re Family Health Services Inc.*, 104 B.R. 268 (Bankr. C.D. Cal. 1989).

96 *In re Family Health Services Inc.*, 143 B.R. 232 (C.D. Cal. 1992), *rev'ing* 104 B.R. 268.

New Hampshire court held that a New Hampshire HMO could not be a debtor under chapter 7 or 11 of the Bankruptcy Code.[97] In 1993, the Seventh Circuit ruled that an Illinois HMO was a domestic insurance company and did not qualify for bankruptcy relief.[98] Over the next few years, a few courts followed the Seventh Circuit decision, including a Georgia court in 1997.[99] There is a dearth of recent reported decisions concerning the eligibility of HMOs for bankruptcy protection.[100]

3. Is a PHO or PO Eligible for Bankruptcy Protection?

The debate concerning the eligibility of HMOs for bankruptcy protection could be extended to other entities unique to the health care industry. As described in Chapter 1 of this *Manual*, a variety of health care entities have become quite commonplace and important in the delivery of health care. They are various components of so-called integrated delivery systems (IDS) and include physician-hospital organizations (PHOs) and physician organizations (POs). Basically, a PO is an organization that is formed generally as a corporation by a variety of otherwise unrelated physicians. The organization contracts on behalf of the individual physicians with insurance companies and other entities to provide, by a series of individual contracts between the PO and the individual physicians, the services of a wide range of health care providers to serve as the individual provider network for a PHO or an HMO. The PHO is an organization that is formed by a hospital and a physician organization. The entity then contracts with the hospital and the PO so that it can "globally" provide facility and individual health care services to, or on behalf of, employers, health plans and insurance companies. These PHOs

97 *Beacon Health*, 105 B.R. at 186.

98 *Medcare*, 998 F.2d at 446.

99 *Master Health Plan*, 1997 U.S. Dist. LEXIS 22880, at *414.

100 There have been some decisions related to the eligibility for bankruptcy relief of entities that sell extended automobile service warranties and other such warranties wherein state officials have argued such entities are domestic insurance companies. Such cases rely, in part, upon the decisions in many of the HMO cases. *See, e.g., In re First Assured Warranty Corp.,* 383 B.R. 502, 518-21 (Bankr. D. Col. 2007) (bankruptcy court applied independent classification test (described *infra*) and found entity was not domestic insurance company). Interestingly, state officials also have sought to rely upon the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015, to argue that even if an entity is eligible for bankruptcy relief, the court should abstain from hearing the case and allow the state insolvency process governing domestic insurance companies to control by arguing for reverse preemption based upon this Act. *First Assured*, 383 B.R. at 531-43.

(and sometimes POs) have many of the characteristics of insurance companies (they accept various forms of financial "risk"), have staff and employees, and can become fairly significant businesses. There is a debate as to whether these entities are *de facto* insurance companies, because they are assuming financial risk that might be considered "insurance-type" risk, as in the case of capitated contracts. A number of states directly regulate these entities just as they regulate insurance companies. Therefore, the eligibility of those entities to file for bankruptcy will be an important developing issue.

Typically, courts use one of three tests to determine whether an entity is a domestic insurance company for bankruptcy purposes. The first test is the "state classification" test, which looks to the entity's classification under the law of the state in which the entity is incorporated. Under this test, the court either reviews state law to determine whether state law classifies the entity as a domestic insurance company, or it may perform a functional analysis and review the applicable state laws to determine whether the entity is essentially the equivalent of a domestic insurer.[101] Under the second test — the "independent classification" test — the court examines the language of § 109(b)(2) of the Bankruptcy Code and construes this exclusion using statutory construction techniques developed under federal common law.[102] Finally, the third test — the "alternate relief" test — examines congressional intent to determine whether federal bankruptcy relief would be a satisfactory alternative to the state law procedures for winding up or reorganizing a particular entity.[103]

101 *See Medcare*, 998 F.2d at 442.

102 *See id.* at 440 (noting but not applying independent classification test per se); *Family Health,* 104 B.R. at 272 (stating that the test is statutory construction by another name); 2 Collier on Bankruptcy ¶ 109.03 (16th ed. 2012) [hereinafter Collier] (describing the test as "an independent classification by the bankruptcy court based upon its own definition of the words of the Bankruptcy Code"). The phrase "independent classification test" seems to have arisen from the *Collier* description. *See In re Cash Currency Exch*., 762 F.2d 542, 548 (7th Cir. 1985) (citing Collier as basis for this test).

103 *In re Republic Trust & Sav. Co.*, 59 B.R. 606, 611 (Bankr. N.D. Okla. 1986). *Republic* recognized the existence of the independent and state classification tests, but concluded that the tests "made sense only as expressions of '*broad discretion* in the bankruptcy courts for the purpose of serving the intent of the Bankruptcy Act.'" *Id.* (quoting 1 Collier On Bankruptcy ¶ 4.05 [2], at 593 (14th ed. 1975) (emphasis added by court in *Republic* but not *Collier*). *See also Beacon Health*, 105 B.R. at 180. However, it appears the alternate-relief test has fallen out of favor with the courts in recent years. *See* 2 Collier ¶ 109.03[3][b] (noting that the two available approaches used by the courts are the state-classification test and the independent-classification test, while declining to mention the alternate-relief test).

There is also a split in authority regarding the eligibility of medical trust funds for bankruptcy relief.[104] Bankruptcy courts in Michigan and Texas have found medical benefit trust funds to be eligible for bankruptcy relief,[105] while a New York bankruptcy court has found that a trust to administer dental, optical and legal expenses was not eligible for bankruptcy relief.[106] In these cases, the courts focused on whether or not the entity was a "person" or a "business trust."

4. What Health Care Entities Are Eligible for Chapter 9 Bankruptcy?

Chapter 9 is a bankruptcy proceeding available to a "municipality," which is defined as a "political subdivision or public agency or instrumentality of a State." Certain hospital systems organized by a county or other local government are potential chapter 9 candidates.

Under § 109(c) of the Bankruptcy Code, an entity may be a debtor under chapter 9 if and only if such entity:

> (i) is a municipality;
> (ii) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by state law, or by a governmental officer or organization empowered by state law to authorize such entity to be a debtor under such chapter;
> (iii) is insolvent;
> (iv) desires to effect a plan to adjust such debts; and
> (v) **(a)** has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; **(b)** has negotiated in good faith with creditors and has failed to obtain the agreement

104 *Compare In re Michigan Real Estate Ins. Trust*, 87 B.R. 447 (Bankr. E.D. Mich. 1987), *and In re Affiliated Food Stores Inc. Group Ben. Trust*, 134 B.R. 215 (Bankr. N.D. Tex. 1991), *with In re Westchester County Civil Serv. Employees Ass'n, Benefit Fund*, 111 B.R. 451 (Bankr. S.D.N.Y. 1990).

105 *Michigan Real Estate Ins.*, 87 B.R. 447; *Affiliated Food Stores*, 134 B.R. 215.

106 *Westchester County Civil Serv.*, 111 B.R. 451.

> of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; **(c)** is unable to negotiate with creditors because such negotiation is impracticable; or **(d)** reasonably believes that a creditor may attempt to obtain a transfer that is avoidable as a preference under Section 547 of the Bankruptcy Code.

The requirements for entering chapter 9 are certainly more burdensome for the debtor than for a debtor filing under chapter 7 or chapter 11. However, for a public hospital system, chapter 9 is the only potential option available to it for bankruptcy protection.

5. *Under What Circumstances Are Nonprofits Eligible for Bankruptcy Protection?*

Although a debtor may be eligible for *voluntary* relief under chapter 7 or chapter 11, not all health care organizations can be threatened by the filing of an *involuntary* petition. An involuntary petition can be filed against a company by at least three creditors holding liquidated claims that are undisputed as to both liability and aggregate an amount of at least $14,425, as indexed under current law.[107] The creditors of a health care organization may not file an involuntary petition against an organization under § 303(a) of the Bankruptcy Code if the organization "is not a moneyed, business, or commercial corporation." (A non-moneyed, nonbusiness and noncommercial entity is known as an "eleemosynary institution").[108] A nonprofit institution that has qualified for tax-exempt status under § 501(c)(3) of the Internal Revenue Code[109] is generally not considered a "moneyed, business or commercial corporation" and thus cannot be subject to an involuntary filing. Nonprofit organizations can, however, file voluntary petitions for bankruptcy under chapters 7 or 11. Although often-insolvent nonprofits merely dissolve their corporations pursuant to state law, there continues to be a strong trend of nonprofits filing to reorganize or liquidate under the Bankruptcy Code. Nonetheless, nonprofit entities that have not tried to satisfy the additional "charitable" requirements

107 11 U.S.C. § 303(b)(1).
108 *See, e.g.*, *In re Cavers Distributors Inc.*, 83 B.R. 921 (Bankr. E.D. Va. 1988).
109 26 U.S.C. § 501(c)(3).

for tax-exempt status may not fall within the protected classes. Courts look to the nonprofit health care organization's charter, its treatment under state law and its business activities in order to determine whether an involuntary petition can be filed against a nonprofit health care organization.

The application of these principles continues to apply after a filing. Once an eleemosynary institution voluntarily files a chapter 11 case, under § 1112(c) of the Bankruptcy Code it cannot be converted to a chapter 7 case unless it consents. This is an important restriction on the rights of creditors and other parties adverse to a debtor in possession and gives significant leverage to a charitable organization that has filed a voluntary chapter 11.