

Rx for Success: Securing Loans With Hospital Real Estate

*Alan B. Wynne**

In this article, the author first briefly explains the recent trend of hospital consolidations, then examines some of the factors that make financing hospital transactions so complex, and finally addresses specific title, environmental, and zoning issues which lenders frequently encounter when securing their loans with the real estate assets of hospitals.

Hospitals are as complex as the bodies they heal. Like the human body, hospitals consist of series of interwoven processes, nerve centers, and relationships—each of which affects and is dependent upon the others. The complexities associated with hospitals create unique issues which must be considered and appropriately addressed in financing transactions. This article will first briefly explain the recent trend of hospital consolidations, then examine some of the factors that make financing hospital transactions so complex, and finally address specific title, environmental, and zoning issues which lenders frequently encounter when securing their loans with the real estate assets of hospitals.

Hospital M&A

Hospital merger and acquisition transactions have continued to increase over the last several years. In fact, in the first quarter of 2012, hospitals completed 23 merger and

acquisitions transactions totaling approximately \$129 million which is a 5% increase when compared to first quarter transactions in 2011.¹ This trend of consolidation results primarily from economic challenges many hospitals face: the rise in costs for providing quality care, the threats of decreasing reimbursements from government-run programs, and an ever-growing number of patients who may be unable to pay for hospital services in a timely manner. These economic realities have particularly affected many non-profit community hospitals which have employed a variety of strategies to effectively manage these challenges. Some local hospitals have ultimately elected to sell themselves to larger, and often for-profit, organizations in order to preserve local access to hospital care and to further their individual missions.

Hospital transactions are frequently more complicated than traditional real estate financing because of the wide variety of properties that most hospitals have and also

* Alan B. Wynne is a Member of Epstein Becker & Green, P.C., in the firm's office in Atlanta. Mr. Wynne is a member of the firm's Corporate Services and Health Care and Life Sciences practices and represents healthcare providers and companies in mergers and acquisitions, sale-leaseback, purchase and sale, and ground lease development transactions. Additionally, Mr. Wynne is a LEED® Accredited Professional through the U.S. Green Building Council (USGBC) and advises clients and developers on issues related to the design, construction, and operation of sustainable projects.

because of the additional regulatory issues which affect certain health care-related real estate. Hospitals often encompass more than the simply the hospital building. The hospital campus may likely include administrative office buildings; medical office buildings which house physician practices; parking structures; and retail operations such as a pharmacy, florist, or cafeteria. Some may also include other business operations such as a nursing or rehabilitation home; day care; a nursing school; or community-based housing for residents who have psychiatric or substance-abuse problems. In addition to the primary hospital campus, many hospitals are part of larger systems which frequently have ambulatory surgery centers, wellness centers, neighborhood clinics, and facilities providing specialty services such as pediatrics, physical therapy, and MRI imaging. These different health care-related services often have different real estate needs so most hospital financing transactions will involve several—or many—types of real estate. For example, in addition to the hospital building in which health services are provided to patients, the administrative offices may be located in a more traditional office building which lenders may treat as commercial office space. Hospitals frequently own—whether outright or through a joint venture with a developer—nearby medical office buildings which are leased to physician practices and health-related services not provided by the hospital. MOB's typically have many leases for relatively small amounts of space and relatively shorter lease terms, rather than the customary “anchor” tenants with longer lease terms found in other commercial office buildings. There may be separate parking decks owned by the hospital but operated by others. Retail operations such as those mentioned above may generate incidental revenue for the

hospital. Lenders often encounter challenges in having the hospital's real estate appraised due to the multitude of uses, many of which have different appraisal and underwriting standards.

Other complexities associated with a hospital's real estate are the laws and regulations imposed on hospitals and other health care facilities. Due to these additional regulations, most lenders expand their due diligence beyond the typical real estate due diligence process. For instance, in a financing transaction involving a hospital's real property, lenders should look beyond the physical condition of the buildings. A prudent lender will make certain the hospital is in compliance with the life-safety inspections performed by the state department of health on behalf of the Centers for Medicare & Medicaid Services. Performed at least annually or perhaps sooner if formal complaints are received, these surveys detail any observed deficiencies for which the hospital is required to submit a corrective plan of action. These corrective plans must be timely and satisfactorily completed as a condition for the hospital's continued participation in the federal Medicare and Medicaid programs and any similar state programs. In addition, the Joint Commission oversees hospital accreditation and performs its own surveys, normally once every three years for organizations which have been accredited with the Joint Commission's Gold Seal of Approval. In addition to addressing patient care and operational issues, these surveys also reveal both critical and non-critical physical plant issues the lender will likely want to have the hospital resolve.

Unique Requirements

Federal Stark law and anti-kickback regu-

lations are others examples of legal requirements unique to real estate owned or leased by hospitals which should be carefully considered. In general, Stark law and anti-kickback regulations govern certain financial relationships. In the case of Stark, a physician is prohibited from referring patients needing designated health services to an entity with which the physician or a member of the physician's immediate family has a financial relationship, unless the arrangement falls within a permitted exception. Anti-kickback regulations are designed, in general, to curtail health care fraud and abuse by prohibiting anything of value being given to influence the referral of business provided through federal health care programs. There are certain "safe harbor" exceptions set forth in the anti-kickback regulations. Certain real estate transactions—particularly the leasing of medical space to or from a physician or a physician-related entity—fall within the purview of these regulations. The financial benefits resulting from any such lease must be carefully analyzed in order to determine whether the agreement is within fair market value. Due to the complicated exceptions and safe harbors, each lease or real estate transaction with a physician, physician-related entity, or potential referral source must be analyzed on a case-by-case basis. The restrictions on the financial benefits conferred by a lease agreement illustrate the significant difference between a lender's review of commercial lease agreements in a traditional real estate transaction and the appropriate due diligence to be performed by a lender in certain hospital lease agreements.

The varied real estate holdings of hospitals and the additional regulatory framework for hospital real estate transactions are not the only factors contributing to the complexity of hospital financing transactions. Due to aged

hospital facilities, certain title, environmental, and zoning issues are frequently encountered by lenders. Many hospitals, particularly those in urban areas, have gradually expanded their campuses through the purchase of many smaller properties, frequently resulting in different title issues that affect only portions of the hospital's assembled parcel. Older tracts, for example, may have been encumbered by race or religious deed restrictions which are now considered unconstitutional to enforce. Other older restrictions—such as restricting the number of horses that may be housed in a carriage house or limiting the use of the property to a single-family residence of a certain size—may be insured over by a title company since those restrictions will likely not be enforced from a practical perspective. Previous financing instruments that were never released are another common title issue that must be addressed, sometimes creatively. Older banks may have closed or merged into different entities after the debt has been satisfied. Occasionally, agencies that had provided earlier bond financing may have subsequently dissolved, thereby making it impossible to obtain a recordable release from that entity. Another common title defect is the appearance of a gap between the adjacent right-of-way and the property line. In many instances, the gap may be illusory, and not actual, because the public right-of-way has expanded from its initial location over the many decades after the hospital had been constructed. In all the above examples, it may be possible to resolve the defect to the lender's and title company's satisfaction through researching local historical records, state bank regulatory filings, and the hospital's internal records.

Environmental Issues

Similar to title defects, typical environmen-

tal issues are generally related to the age of the hospital's buildings as well as the passage of time. One of the most frequently encountered environmental problems relates to previous underground storage tanks that had leaked on the property. In most cases, the leaking tank was an older, single-walled tank that has since been replaced by a newer, double-walled tank. Often, the leaking storage tanks continue to be included in databases maintained by the state environmental agency because the appropriate filings were not submitted in order to close the state's file. Occasionally, the information needed to close the state's file may be available from either the hospital or the hospital's contractor which removed and disposed of the leaking tanks. It is often possible to work with the state environmental agency to close the file by submitting current environmental reports or by determining whether the amount of contamination previously reported still requires reporting under the standards currently in place.

There are also common zoning issues related to hospital properties which lenders must normally address. For older hospitals, the local building department may be unable to confirm whether or not a certificate of occupancy had previously been issued. In such situations, many local building departments are willing to confirm the absence of a certificate of occupancy is not deemed itself to be a violation of the local building codes. Older hospital properties are normally treated as legal non-conforming as to both building codes and use. Although local zoning depart-

ments may confirm the "grandfathered" status conferred upon the buildings that pre-date the current zoning ordinances, lenders should further inquire as to whether a transfer of ownership will result in the loss of "grandfathered" status and whether the hospital can be re-built with the same non-conforming characteristics in the event of damage or destruction. A city or county may also exempt hospitals it owns or operates from the zoning requirements, but that exemption might not transfer to a new owner which is not associated with the city or county.

Conclusion

As the foregoing examples suggest, the real estate assets of hospitals are not typical commercial properties. Physical plant issues are frequently revealed in on-site surveys performed by regulatory and accrediting agencies. A hospital's real estate is also subject to distinctive laws—such as Stark and anti-kickback regulations—that do not apply to most other properties. Additionally, the age and gradual expansion of many hospital campuses may create title, environmental, and zoning issues that may not commonly affect other commercial properties. As the volume of hospital M&A transactions continues to increase, lenders should carefully review and appropriately modify their due diligence processes to account for the uniqueness of a hospital's real property.

NOTES:

¹*The Daily Briefing*, April 27, 2012.