# POINTING THE FINGER AT GHOSTS

**Potential Dangers Associated with Undercapitalization of Nursing Homes**

**Scott A. Johnson**
**Special Assistant Attorney General**
**State of Mississippi**
**Post Office Box 220**
**Jackson, MS 39205**
**Telephone: (601) 359-4230**
**Facsimile: (601) 359-4231**
**SJOHN@AGO.STATE.MS.US**

(Note: This paper would not have been possible, but for the time and efforts of Special Assistant Attorney General Lisa Blount and Legal Intern Rita Silin.)

My name is Scott A. Johnson, and I have been employed as a Special Assistant Attorney General with the State of Mississippi for over six (6) years. I currently serve as Trial Counsel for the different Divisions and assist in litigation in various contexts. In my tenure at the Attorney General's Office, I have served as Antitrust Counsel, Director of the Medicaid Fraud Control Unit and Director of the Public Integrity Division (of which the Vulnerable Adults Unit is a subdivision). Prior to accepting employment with the Attorney General's Office, I had been engaged in the practice of law in the private sector since September of 1993.

As Director of the Medicaid Fraud Control Unit, I became familiar with the inspection process of nursing homes administered by the Mississippi Department of Health and its ability to levy and collect fines for substandard performance. Nursing homes in rural states comprise only a small fraction of the approximately 17,000 nursing homes currently operating in the United States. For example, Mississippi now has a total of two hundred and one (201) nursing homes, with the majority of its eighty-two (82) counties having only one home. Accordingly, a geographical monopoly of sorts exists with respect to availability of nursing home care within a sixty-plus mile radius. In the absence of vigorous regulatory practices (i.e., the inspection of homes, and the levying and **collection** of fines) such as those employed by the Mississippi Department of Health, family members of a resident could easily be confronted with the choice of leaving a loved one in a conveniently located, but substandard home, versus moving the resident to a superior but distant facility.

Prior to beginning my discussion of the inherent dangers associated with the proliferation of nursing home ownership by private equity firms (in the absence of adequate and available income streams, as discussed hereafter), I am reminded of a prediction made in the late 1960's by Melvin Belli, one of America's preeminent trial lawyers, that went something like this: With enough research, time and expense, scientists could figure out how to develop a self-contained, mobile telephone and, further, they could also figure out how to make amputated limbs regenerate. Mr. Belli went on to explain, however, that while we could expect the mobile phone within the relatively near future, the regenerative limb would probably remain confined to the realm of science fiction. Why? Because even forty years ago, Mr. Belli realized that almost everyone could benefit from the convenience of a mobile phone and would be willing to pay for it. Whereas, to the contrary, the world only has a finite number of amputees, with limited buying power. **In the absence of premature death, we are all going to get old, and the majority of us will require long-term health care in a residential setting.** It is, therefore, time to look past the horizon to adopt and put into practice any remedial actions which are necessary to protect our elderly loved ones today and ourselves tomorrow.

<u>Example of Common Mississippi Nursing Home Corporate Structure</u>

An example of a nursing home in Mississippi owned by a private equity firm is Trinity Mission Health & Rehab of Holly Springs in Holly Springs, Mississippi. For ease of discussion, I am providing its corporate structure as it existed prior to July of this year. See "Exhibit A," attached hereto. Fortunately, Mississippi Code § 43-13-121(7) (1972, as amended), provides that in order for a nursing home to be enrolled in the State Medicaid Program, the nursing home must provide the identity of all entities owning five percent (5%) or more of the home. In this example, we have two (2) owners which each own thirty-five (35%) and two (2) additional owners which each own fifteen percent (15%). As detailed in the attached exhibit, the ownership of the two larger interest holders is further subdivided.

In the event of inadequate insurance and the absence of a minimum standards performance bond, where does this corporate structure leave a state regulator attempting to levy a fine or assessment for the provision of substandard care? In this particular case, despite the maze of ownership interest, the assets of the nursing home (e.g., buildings, furniture, equipment, etc.) remain intact and subject to placement of a lien or attachment via the appropriate legal process. This corporate structure is a mere continuation of the company from which it was initially purchased and, as such, is obligated for all liabilities, both existing and contingent, based on its (or "their" may be more appropriate) acquisition of assets. *See Stanley v. Mississippi State Pilots of Gulfport*, 951 So.2d 535 (Miss. 2007). More importantly, from the vantage point of a State regulator, this facility produces an income stream which would be sufficient to cover all conceivable fines or penalties which might be levied by the Mississippi Department of Health. Payments made to this nursing home on behalf of residents covered by Medicare and/or Medicaid tend to lag for weeks after services are rendered. Accordingly, there is no danger of the money being shielded from utilization for payment of any pending fine.

<u>Hypothetical Corporate Structure (Asset Divestiture by Licensee)</u>

Now let us compare the above structure to what is becoming more prevalent nationwide. Nursing Home ABC sells one hundred percent (100%) ownership to Holding Company DEF, LLC. In turn, DEF sells the actual building, furniture, beds, and equipment to GHI, LLC, for an artificially low purchase price. GHI leases the building and other items back to DEF at an artificially high price. Although DEF is now the nursing home licensee and actual operator, it has effectively divested itself of tangible assets, other than accounts receivable. Accordingly, in the absence of insurance, a performance bond, or a sufficient income stream, such asset divestiture could make it difficult, if not impossible, for a State regulator to collect (as opposed to levy) fines and penalties for substandard performance.

This paper is not meant to be a survey of the law of various states with respect to a creditor's ability to identify and attach divested assets. Accordingly, I will confine my discussion to the prevailing law in Mississippi for discussion purposes. The general rule is that a company which acquires the assets of another company is NOT obligated for the liabilities of the acquired company, unless one of four (4) following exceptions apply: "(1) the successor expressly or impliedly agrees to assume the liabilities of the predecessor; (2) the transaction may be considered a de facto merger; (3) the successor may be considered a 'mere continuation' of the predecessor; or (4) the transaction was fraudulent." *Stanley,* 951 So.2d at 538 (citing *Paradise Corp. v. Amerihost Dev., Inc.*, 848 So.2d 177, 179 (Miss. 2003)(citations omitted)).

Although a unique situation may exist which justifies an argument to the contrary, neither exception (1), (2) or (3) is applicable on its face with respect to the DEF scenario. How about exception (4)? In order for a regulatory agency to attempt to collect a penalty or fine via attachment of the divested assets of the nursing home, that agency would have to show that the sale of those assets was fraudulent. Herein, a large problem lies. First, because nursing homes are not fungible entities (i.e., the same structure and equipment in one location may be worth much less than that in another location because of vastly different local economies, real estate prices, availability and costs associated with attending physicians, etc.), it would be almost impossible to prove that the sale price was significantly below an "acceptable" fair market value. Further, in Mississippi, any such allegation of fraud would have to be proven by clear and convincing evidence, as opposed to the normal lower civil standard of preponderance of the evidence. Second, in some states (e.g., Oregon), undercapitalization of a business entity, such as example DEF here, can serve as the basis for "piercing the corporate veil," thus rendering the transferred assets fair game for attachment. However, this theory has been expressly rejected by the Mississippi Supreme Court. *Stanley*, 951 So.2d at 542.

In the absence of an adequate income stream, applicable insurance or a performance bond, the State regulator's potential for relief via litigation would be bleak in most cases. Further, the State regulator would be subject to incurring litigation expenses in its efforts to follow the assets. While the law applicable in this regard is certainly going to vary from state to state, Mississippi's law is demonstrative of the obstacles which may be incurred in seeking fines and penalties through attachment of fraudulently divested assets.

In the DEF scenario above, the norm would be for GHI to then lease the building, furnishings and equipment to DEF at artificially high prices (i.e., again, at the very upper limits of an acceptable range so as not to risk a finding of fraud via an adjudication in a Court of proper jurisdiction). Further, DEF is then left with debt in the form of leases and any contracts with GHI. At that point, DEF's only remaining significant asset is its stream of income predominantly, if not totally, from Medicaid/Medicare.

Based on its contractual obligations for rent of building, lease of equipment and management fees, DEF can then adjust its subsequent yearly cost reports to reflect an increase in the overall expense of patient care–thereby likely resulting in an increase in the per diem rate which the nursing home is paid to care for its patients. In other words, the more it costs to provide care, the more Medicaid pays. It is my understanding that this policy is meant as an attempt to keep profit margins per patient within a reasonable range of deviation among various providers.

To further compound the ABC/DEF situation above, the growing trend is for DEF to hire JKL, LLC, as the "management company." By JKL lowering costs by reducing the number of registered nurses by ratio to patient and/or replacement by licensed practical nurses (significantly less trained) and other cost-cutting measures, then DEF's profits substantially increase allowing significant dividend payments to be paid to its shareholders. The management company is basically "management personnel." Other than possible ownership of some computers and other office equipment, JKL has no assets which could be subject to the placement of liens and/or attachment by State regulators for misconduct as possibly provided by statute in some states.

The ABC/DEF scenario is meant to highlight problems associated with insolvent licensees due to the divestiture of assets, and purposely does not discuss DEF's potential income stream for that reason. Further, as it relates to my capacity as a State regulator, the interests of potential plaintiffs in being able to recover monetary judgments in negligence/malpractice suits is NOT a consideration in my evaluation of the current landscape and trends with respect to the ownership structure of nursing homes.

From a fine or penalty standpoint, the State regulator is not interested in the source of the demanded funds, but as to their existence. Accordingly, if: (1) there is sufficient lag-time between payment being due from a payor (e.g., Medicaid) and a potential fine having to be paid by the nursing home licensee AND (2) the payment due is normally, if not always, greater than the potential fine; then the adverse consequences of undercapitalization subside.

By the same token, if State regulators "hold the line" (such as I have determined to be the norm in Mississippi) on staffing requirements, the quality and nutritional value of food, upkeep of physical facilities, *et cetera*, by the levying and collection of penalties and fines, then the undercapitalization of the nursing home licensee does not equate to the existence of substandard services, as sometimes associated with ownership by private equity firms.

Potential Remedies to Combination of Undercapitalization and Inadequate Income Stream

As a State regulator, the ability to levy and collect fines and penalties is paramount. In order to insure adherence to minimum standards, the regulator has to be able to get into the licensee's pocketbook, rather than invest its limited capital and personnel resources in attempting to follow the assets in the complex ownership structure evermore prevalent in nursing homes. When comparing potential fines to "owed, but yet to paid" income streams in Mississippi, our nursing home residents appear to be adequately protected (barring the occurrence of such egregious behavior, the scope of which has yet to be encountered)–as well as can be protected by a regulatory scheme. Based on my research to date, I have been unable to locate an example wherein the Mississippi Department of Health levied a fine against a nursing home licensee for substandard conduct, or any type of deficiency or rule violation, which has not been paid in full.

In the absence, however, of an adequate pending income stream to the nursing homes in his or her state in relation to potential fines or penalties, a State regulator would be wise to seek legislation requiring one or more of the three following options:

(1) Minimum capitalization requirements placed on the Licensee for a Certificate of Need (CON) to be granted or for whatever other type of statutory mechanism exists for the opening of a new nursing home (or for a transfer of ownership in an existing facility);

(2) Minimum insurance requirements with respect to fines and/or penalties levied by

State regulatory agencies; and/or

(3) Minimum bonding requirements with respect to fines and/or penalties levied by State regulatory agencies.

Although Alternative 1 would have the dual effect of prohibiting the nursing home licensee from rendering itself totally judgement proof (as seems to be the main animus for asset divestiture and complex corporate structuring), Alternatives 2 and 3 impact would inure solely for the benefit of State regulators, with no collateral benefit to potential Plaintiffs against the licensee. The lingering inquiry then appears to be two-fold:

(1) If an adequate income stream exists by way of payment of Medicaid/Medicare benefits to nursing home licensees so as to insure payment of regulatory fines and penalties, is there a justification for addressing undercapitalization from a regulatory standpoint?

(2) Can the interests of nursing home residents be adequately protected through rigorous enforcement of minimum standards by State regulatory agencies?

Respectfully submitted, this the 13th day of November, 2007.

Scott A. Johnson

Special Assistant Attorney General
State of Mississippi

## SALE OF TRINITY MISSION HEALTH & REHAB OF HOLLY SPRINGS
## HOLLY SPRINGS, MISSISSIPPI

Owners with a 5% or More Interest

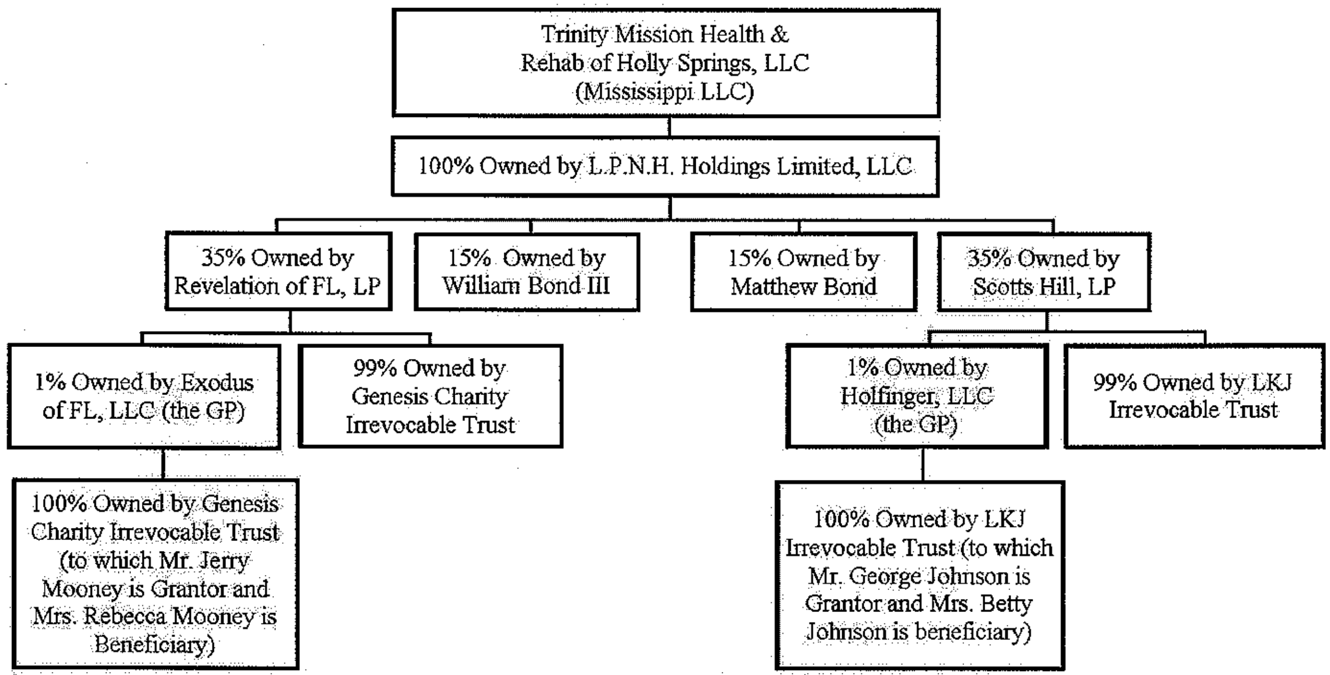


**EXHIBIT A**