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Feature

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Lessons Learned from Senior Housing Bankruptcies

Although the senior housing industry was generally a resilient real estate asset class during the recent recession, perhaps because of the industry's "need-driven" nature, the sector was not immune from serious distress. Hit particularly hard during the recession were certain continuing care retirement communities (CCRCs).² While the economy and the housing market — to which the senior housing industry is inextricably linked — continues to recover from the deepest recession since the 1920s, it is important to reflect on the challenges that are presented by the current economic downturn to identify the lessons that were learned, and hopefully avoid — or at least better navigate — such challenges when they invariably arise again. Of course, the economy is cyclical, and even the most "recession-proof" asset class will always be subject to meaningful distress.

The Roots of the Distress: Pre-Recession Expansion

In the years preceding the recession, market participants, including nonprofit sponsors, real estate developers, bond underwriters, feasibility consultants, banks and bond funds, were enthusiastic, perhaps overly so, on the CCRC market. Indeed, bond financings for nonprofit senior-living facilities in 2006 and 2007 eclipsed the level of financings

in any of the five preceding years.³ The volume of nonprofit senior-living bond financings spiked in 2007, which set a record with more than \$7 billion of bonds issued to support CCRCs, followed only by the volume in 2006 (approximately \$6 billion).⁴ Volumes close to those levels had not been seen since 1998 and 1999 when bond issuances supporting CCRCs were approximately \$5 billion each year.⁵ In fact, for the 10-year period of 1996-2005, the average annual volume of senior living financings was approximately \$3.6 billion.

The Fallout from Easy Money: Post-Recession Defaults

With every boom comes a bust, and the cumulative default percentage rate for CCRCs rose from under 4 percent in 2007 to approximately 7 percent in 2011.⁶ Not surprisingly, accompanying these historic default rates were numerous restructurings and bankruptcy cases in the CCRC industry, including, but not limited to, Erickson Retirement Communities LLC,⁷ a national operator of more than 20 CCRCs involving billions of dollars of debt; Fairview Ministries,⁸ a two-campus facility operating in Downers Grove and Rockford, Ill., with approximately \$57 million in tax-exempt debt; The Clare at Water Tower Place,⁹ a luxury CCRC in downtown Chicago that was encumbered by approximately \$229 million in tax-exempt



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1 For full disclosure, the author represented parties in the bankruptcy cases of *Erickson Retirement Communities*, *Fairview Ministries*, *The Clare at Water Tower Place*, *St. Mary of the Woods* and *Clare Oaks*.

2 For an introduction to CCRCs, their typical financial models, and their operations, see Scott B. Davis and Paul I. Melville, "Current Developments in CCRC Restructuring and Workouts," XXXI *ABI Journal* 5, 22, 102-04, June 2012; see also Louis E. Robichaux IV and Russell A. Perry, "CCRCs: Hypertension in the Geriatric Years," *ABI Health Care Committee Newsletter*, Vol. 10, No. 1, January 2013; Nancy A. Peterman and Elizabeth J. Sichelka, "Continuing-Care Retirement Facilities: Are Residents' Deposits Recoverable?," XXXIX *ABI Journal* 4, 20, 78-79, May 2010; and George R. Mesires, "Continued Pressure on Senior Living Market May Put CCRC Entrance Fees at Risk," *ABI Health Care Committee Newsletter*, Vol. 7, No. 2, May 2010.

3 "Senior Living Finance 101 and Risk Management 101," presented at Ziegler's 2013 Senior Living Finance and Strategy Conference, held Sept. 25-27, 2013, in San Antonio (Ziegler's 2013 Senior Living Finance Conference), available at http://eziegler.com/Files/130925_1a_SL%20Finance%20and%20RM%20101.pdf.

4 *Id.*

5 *Id.*

6 "2013 Institutional Investor Panel," presented at Ziegler's 2013 Senior Living Finance Conference, available at http://eziegler.com/Files/130925_12_Investor%20Panel.pdf.

7 *In re Erickson Retirement Communities LLC (In re Erickson)*, Case No. 09-37010 (Bankr. N.D. Tex. 2009).

8 *In re Fairview Ministries Inc. (In re Fairview)*, Case No. 11-04386 (Bankr. N.D. Ill. 2010).

9 *In re The Clare at Water Tower (In re The Clare)*, Case No. 11-46151 (Bankr. N.D. Ill. 2011).

debt; St. Mary of the Woods,¹⁰ a CCRC in Avon, Ohio, with approximately \$34 million in tax-exempt debt; Clare Oaks,¹¹ a CCRC in Barlett, Ill., with approximately \$137 million in mainly tax-exempt debt; Glenmoor,¹² a CCRC in World Golf Village, Florida, with approximately \$55 million in tax-exempt debt; and Deerfield Retirement Community,¹³ a retirement home in Urbandale, Iowa, with approximately \$41 million in tax-exempt debt. Although most of the serious distress involved the nonprofit CCRC sector, the for-profit sector has not been immune from bankruptcies, including the recent case of *HealthBridge Management*, an operator of five skilled nursing facilities that filed for bankruptcy protection in Connecticut last year.¹⁴

Causes of the Distress

The most obvious and undisputed factor contributing to distress in the senior-housing market was the economic and housing crisis, especially for those new or expanded facilities that opened during the downturn.¹⁵ Other causes are heavily disputed, likely because each situation is fact-specific and the various constituents seek to deflect blame. However, to cite only the financial downturn as a contributing factor to the distress avoids the introspection necessary for constructive analysis.

There are numerous factors that contributed to the operational and financial distress of the industry, including, but not limited to, delayed and expensive development overruns,¹⁶ aggressive fill-up assumptions,¹⁷ unrealistic assumptions of continued growth in home values, higher-than-expected operating expenses, relatively aggressive lending and investment environments, misaligned interests between short-term creditors and long-term investors,¹⁸ and limited or irrelevant financial sensitivity analysis to probe “what-if” scenarios. Together, these factors led to overleveraged capital structures and undercapitalized borrowers that had little financial flexibility if things went wrong.

When these challenged facilities invariably need restructuring, either out of court or through a bankruptcy proceeding, tensions naturally arise among the various constituents. Indeed, a senior housing debtor might seek to (1) address the underlying erroneous assumptions concerning the housing market, including adjusting entrance fees downward to

account for the decline in housing prices and allowing for a longer fill-up period; and (2) address the balance sheet, either through a reduction in debt or by raising capital. Not surprisingly, these goals are often antithetical to bondholders and other investors who seek repayment on as close as original terms as possible.

Early CCRC bankruptcy cases often resulted in the sales of substantially all of the debtor’s assets, usually at a steep discount.¹⁹ One such example involves one of the most high-profile CCRCs to file for bankruptcy, The Clare at Water Tower Place. At the time of the \$229 million bond issuance, The Clare’s financial performance was premised on the following assumptions: (1) no equity contribution; (2) a debt-service-coverage ratio of 0.67; (3) average home prices in the market of \$408,000; (4) average entrance fees of \$825,000; and (5) 13.8 move-ins per month during the first 12 months. The debtor filed a liquidating plan that provided for the sale of substantially all of its assets. After an auction was conducted, Senior Care Development LLC acquired substantially all of the assets for approximately \$53 million.²⁰

More recently, nonprofit CCRC bondholders, a relatively discrete and concentrated group of investors, have demonstrated a willingness to reorganize distressed CCRCs instead of urging a sale through the bankruptcy process,²¹ perhaps because they had been stung by poor recoveries in asset sales. As reorganizations generally yield better returns, this apparent trend should be encouraging to all constituents.

Lessons Learned and Best Practices

While there are still pockets of distress in the senior housing industry, it is appropriate to reflect on lessons that were learned and identify the best practices that financial advisers, lawyers, consultants, board members and other market participants can employ to either avoid or be better prepared for the operational and financial challenges of the future. Here are some points to consider:

Always ask, “what if?” This question should begin in the community-development phase. This means trying to poke holes in all of the material project’s assumptions, including whether the facilities will fill up, the pace of home sales, consumer preferences and operational expenses. The goal should be an honest assessment of the senior housing facility’s position in the marketplace before it opens its doors and before any subsequent financing. Challenge the conventional thinking by pressing other advisers to defend their assumptions.

Demand engagement from the board of directors. Needless to say, the boards of directors of nonprofit senior housing operators are not “junior varsity” boards. Board members must be oriented with, educated about and engaged

10 *In re Franciscan Communities St. Mary of the Woods Inc. (In re St. Mary of the Woods)*, Case No. 11-19865 (Bankr. N.D. Ohio 2011).

11 *In re Clare Oaks*, Case No. 11-48903 (Bankr. N.D. Ill. 2011).

12 *In re Life Care St. Johns Inc.*, Case No. 3:13-bk-4158 (Bankr. M.D. Fla. 2013).

13 *In re Deerfield Retirement Community Inc. (In re Deerfield)*, Case No. 14-00052-11 (Bankr. S.D. Iowa 2014).

14 *In re 710 Long Ridge Road Operating Company II LLC, et al.*, Case No. 13-653 (DHS) (Bankr. D.N.J. 2013).

15 See, e.g., *In re The Clare*, Declaration of Judy Amiano in Support of Chapter 11 Petition and First-Day Motions of The Clare at Water Tower, ¶ 33 (“Prospective senior residents are having difficulty selling their homes and have lost significant amounts of their retirement funds in the financial market, making it difficult, if not impossible, for them to move into or remain in senior housing facilities.”).

16 See, e.g., *id.* at ¶ 34 (“Moreover, the delays in construction forced The Clare to open its doors subsequent to the collapse of Lehman Brothers — an extremely volatile time for the CCRC industry (particularly high-end developments such as The Clare) in light of the historic drop in the value of homes and investment portfolios.”).

17 See, e.g., *In re Deerfield*, Declaration of Scott M. Harrison in Support of the Debtor’s Chapter 11 Petition and First-Day Motions, Dkt. 14, ¶ 14 (“The recent economic downturn [has] had significant adverse impacts on the Debtor. Many factors, including the steep decline in the residential real estate market, which impaired the ability of some potential residents to sell their houses and then move into the Facility, and increased competition, resulted in the Debtor’s failure to attract residents as quickly as was forecasted.”).

18 See also Robichaux and Perry, fn.2 (“If a CCRC faces restructuring before its short-term bonds are repaid, it likely must solve the inherent tension between short-term holders that usually prefer a near-term cash recovery (presumably at a discount) and long-term holders that usually are more patient and willing to be paid out over time (presumably at a higher recovery). Developing a workable solution for both viewpoints can be quite a challenge, especially if short-term holders aggressively pursue an exit.”).

19 See, e.g., *In re Erickson* (substantially all assets acquired by Redwood Capital Investments LLC and affiliates for approximately \$365 million); *In re Fairview* (substantially all assets acquired by LifeSpace DG LLC for approximately \$20 million); *In re St. Mary of the Woods* (substantially all assets acquired by Orion Properties Eleven LLC for approximately \$18.8 million).

20 “Distressed Assets and Strategic Divestitures: Restructure, Sell or Purchase — How to Analyze Your Options,” presented at HJ Sims 2013 Late-Winter Conference of Nonprofit and Proprietary Senior Living Providers, Feb. 26-28, 2013, available at www.hjsims.com/lwc/data/05-Distressed%20Assets%20and%20Strategic%20Divestitures.pdf.

21 See, e.g., *In re Clare Oaks*, Dkt. 437 (order confirming bond restructuring via reorganization plan); *In re Virginia United Methodist Homes of Williamsburg Inc.*, Case No. 13-31098 (Bankr. E.D. Va. 2013), Dkt. 187 (order confirming bond restructuring via reorganization plan, dated Nov. 18, 2013); and *In re Deerfield*, Dkt. 15 (Pre-Packaged Plan of Reorganization of Deerfield Retirement Community Inc., dated Nov. 13, 2013).

in the organization and the industry. Senior housing is complex; therefore, board members must be required to expend the necessary due diligence to become familiar with the operations and the industry.²² Moreover, the board must be educated in its fiduciary duties, and professional advisers should make appropriate presentations when called upon to impart this necessary information.

Consider financial outliers carefully, and watch for negative trends. When considering financial metrics, is the data point really an “outlier?” Ask the hard questions about that reduced census number, a dip in the debt-service-coverage ratio or days’ cash-on-hand, or the basis for delaying capital expenditures. Look for trends in chronic “outliers.” Is a negative trend line forming? If the organization fails to identify, or worse, disregards, a negative trend line, it might find itself with not enough runway to address the underlying problem.

Plan for contingencies. Especially plan for the contingencies for which no one is planning.

Be transparent with stakeholders. A leading senior housing commentator once suggested that the communities that will survive and thrive are those that are transparent and accountable to stakeholders, which include the residents and their families, service and health care partners, payors, policymakers and capital providers.²³

Communicate with constituents when times are good. Even when the senior housing facility is operating smoothly, communicate often with the stakeholders, including the creditor constituency. Be responsive to creditor inquiries. Share your successes and invite constituents to the facility to observe the business.

Communicate with constituents when times are bad, early. The earlier that management, the board or directors and the company’s advisers can identify and communicate a problem to its creditors and then do something concrete to address it, the better. All too often companies act paralyzed, failing to make the hard decisions that are necessary to address the underlying problems.

Do not point fingers; take ownership. When a string of troubling data points appear to form a negative trend line, do not point fingers. Take action, and advise the creditor constituency as soon as the problem is identified and corrective action is planned. Identify potential solutions, even if it means a merger, affiliation or some other form of loss of control. Doing nothing might create a tipping point — from an out-of-court restructuring into a free-fall bankruptcy.

Build consensus; don’t surprise. The best results are attained when there is consensus around a solution, ideally a consensual, out-of-court solution. These situations are complex and dynamic, and investors and residents do not like surprises, so provide ample time for discussion, collaborative problem-solving and consensus-building. The worst results are realized when a company files a free-fall bankruptcy without the support of its creditors. In such cases, vital relationships are strained, the bankruptcy case becomes protracted, and professional fees mount, draining the community of valuable time and money that might have been better spent

developing a solution that serves all of the constituents, or at least mitigates the negative impact of a restructuring.

Conclusion

Senior-housing communities are dynamic facilities that pose unique challenges when faced with financial distress. Hopefully the aforementioned considerations will provide better guidance to practitioners and professionals who advise such facilities in an industry that relies on trust, stability and collaboration to serve an ever-increasing segment of the U.S. population. **abi**

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²² See “State of Senior Living and the Senior Living Capital Markets,” presented at Ziegler’s 2013 Senior Living Finance Conference, available at http://eziegler.com/Files/130925_2_State%20of%20Senior%20Living_Handout.pdf.

²³ See “Senior Living: Today, Tomorrow and Imperative for the Future,” presented by Robert Kramer, President, National Investment Center, presented at Ziegler’s 2013 Senior Living Finance Conference, available at http://eziegler.com/Files/130925_19_Future%20of%20Senior%20Living.pdf.