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IntegraMed and Assignability of Management Services Agreements in Bankruptcy

by Mike Parisi, Jonathan Edwards, and Adam Monich

In recent years, medical practices have increasingly attracted private equity investors seeking to consolidate various specialty practices, which typically borrow money to effectuate their strategy. A controversial ruling in a recent Chapter 7 case in the U.S. Bankruptcy Court for the District of Delaware, *In re IntegraMed Holding Corp*. (No. 1:20-bk-11169), has caused both private equity investors and secured lenders to reexamine the perceived collateral packages securing such credit facilities.

MSO Structural Overview

Many states prohibit non-physicians from owning professional medical practices or controlling the practice of medicine to protect the public from perceived dangers of layperson influence over the practice of medicine. However, private equity firms may establish management services organizations (MSO), sometimes referred to as a physician practice management company or an administrative services organization, to execute on their investment strategy, in part, in those states. An MSO generally refers to a business entity that provides nonclinical practice management services to a medical practice (e.g., billing and collections, payroll and IT services). In exchange for the ongoing provision of management and administrative services, a medical practice pays a management fee to the MSO.

The extent of the relationship between the medical practice and the MSO has traditionally varied depending on the type of MSO arrangement. On one end of the spectrum, an MSO might provide a limited set of services, such as revenue cycle management and IT (a "vendor-like MSO structure")—in these instances, the MSO relationship looks very much like a vendor or other outsourced service provider, and the management fees are priced accordingly. On the other end of the spectrum, an MSO might provide all services necessary to operate a medical practice short of employing professionals and overseeing the clinical aspects of the medical practice (a "comprehensive MSO structure")—in these instances, the MSO relationship appears similar to the relationship a medical practice may have with its parent companies in a vertically integrated platform (e.g., a medical practice owned by a hospital system or insurance company) in states where non-physician ownership of a medical practice is permitted. In each case, the medical practice enters into a management services agreement (MSA) with the MSO. Under most comprehensive MSO structures, the medical practice, the physicians that own the medical practice, and the MSO also enter into a stock transfer restriction agreement (STRA), which is a crucial agreement governing the relationship among them.

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Upon the occurrence of a triggering event (e.g., any breaches of obligations owed by the physician to the MSO or the medical practice), STRAs permit the MSO to require the transfer of the equity interests of the medical practice from the breaching physician to another physician that is acceptable to the MSO.[1] Many MSOs (and their lenders and equity investors) view these additional agreements as necessary for the MSO to invest substantial resources into the practice, including in some cases IT and other capital improvements.

Private equity firms often seek financing from banks or alternative lenders to fund both a portion of the initial investment by their MSO portfolio company into a platform medical practice and, thereafter, a growth strategy of providing management services to other medical practices in the sector. Within the typical universe of assets pledged to a lender as collateral to secure its loans to an MSO are the rights and interests of the MSO under the MSAs and, in the case of comprehensive MSO structures, the STRAs and other additional agreements among the medical practice, physician owners, and MSO. A key underwriting assumption of most lenders that finance MSO structures is that, in a restructuring scenario, the lenders will have the ability, whether in or out of a bankruptcy proceeding, to foreclose on the MSO's assets (including the MSO's rights in the MSAs, any STRAs, and any other related agreements), sell the MSO business to a new financial or strategic buyer, and in the case of comprehensive MSO structures, potentially require the medical practice to replace the existing physician owner with another physician owner approved by the lender or buyer. Given the indirect relationship between an MSO's lenders and the medical practices, this "collateral assignment" of the MSO's rights under the MSAs, STRAs, and any other related agreements is critical to those lenders.

A fundamental consideration of investing in MSO structures, whether through a debt or equity investment, is the need to retain the physicians at the various medical practices to continue the revenue generation and maintain the enterprise value. Restructuring MSOs presents unique challenges, not the least of which is the need to manage and incentivize the physicians during financial distress. A recent bankruptcy court ruling involving a vendor-like MSO structure illustrates just how delicate MSO restructurings can be and highlights why MSO lenders must understand and appreciate the structure and contracts underpinning their loan.

The *IntegraMed* Case

IntegraMed, a private-equity-backed developer and manager of physician clinics and specialty outpatient health care facilities, routinely entered into MSAs with medical practices whereby the physicians associated with the practice would practice medicine and IntegraMed would manage both the billing and collections, as well as long-term strategy, budgeting, marketing, hiring, and business development. IntegraMed filed a Chapter 7 bankruptcy petition on May 20, 2020. With the intent to liquidate assets for the benefit of IntegraMed's creditors, the Chapter 7 trustee filed a motion requesting approval to sell substantially all of IntegraMed's assets free and clear of liens, claims, and encumbrances under Section 363(f) of the Bankruptcy Code. As part of the sale motion, the trustee sought the ability to assume and assign the MSAs to a prospective third-party purchaser. Nine medical practices counterparty to MSAs with IntegraMed objected to the sale, arguing that Section 365(c)(1) barred the trustee from assuming and assigning the MSAs without the medical practices' consent. The *IntegraMed* court held that Section 365(c)(1) of the Bankruptcy Code barred the IntegraMed trustee from assuming and assigning certain of its MSAs as part of an upcoming auction of IntegraMed's assets.

When a debtor files a bankruptcy petition, the debtor-in-possession or trustee has the option of assuming or rejecting the debtor's executory contracts. In the bankruptcy context, under an executory contract both a debtor and another

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1 In certain states subject to heightened regulatory scrutiny (e.g., New York), option agreements are used in lieu of STRAs and the right to replace the "friendly physician" is held by another physician rather than the MSO itself.

party still have material unperformed obligations. The Bankruptcy Code also allows a debtor to assume and assign its executory contracts to a third party despite any provision in the contract that limits its assignability. This is a valuable tool for a debtor or trustee, especially in a sale of substantially all the debtor's assets.

Section 365(c)(1), however, provides one of the few limitations on the debtor's ability to assume and assign its executory contracts. That section provides that the trustee may not assume or assign an executory contract, whether or not the contract prohibits or restricts assignment of rights or delegation of duties, if applicable non-bankruptcy law excuses a nondebtor party to the contract from accepting performance from or rendering performance to an entity other than the debtor or debtor-in-possession. The classic example of a type of contract that falls within the Section 365(c)(1) exception is a "personal service contract"—contracts that are unique to the performer (e.g., an athlete or musician).

In a July 10, 2020 bench ruling, the Delaware bankruptcy court held that the debtor's MSAs fell within the scope of Section 365(c)(1) and therefore could not be assumed and assigned as part of the trustee's sale of IntegraMed's assets. The court partially relied on a previous Delaware bankruptcy court opinion, *In re EBC I Inc.*, in which the court held that contracts founded on trust and confidence in a debtor's unique attributes and experience fell within the scope of contracts barred from assignment pursuant to Section 365(c)(1). The court also quoted extensively from *In re Planet Hollywood International Inc.*, a Delaware federal district court case where the court held that "a personal service contract is a contract in which the parties rely on such qualities as character, reputation, taste, skill or discretion of the party that is to render performance."

In analogizing the practice of medicine with the practice of law, the court observed that there are two aspects to any professional's practice: the actual practice and the running of the business. The court then distinguished between the "performance of mundane but important tasks such as billing and collection [and] payment of vendor bills" on one hand, with tasks that require "judgment, discretion, and compromise," such as "creating budgets, strategic planning, merger decisions, and hiring" on the other. Evaluating the MSAs as a whole, the court concluded that IntegraMed's expansive responsibilities and equal say in the management of the medical practices were effectively "designed to let the doctors practice medicine without having to be distracted by the mundane aspects of their business" and "to ensure compliance with state and federal laws surrounding the practice of medicine."

From there, the court surmised that under the MSAs, IntegraMed had a much more significant role than merely billing, collections, and mere administration; in fact, they were, "in essence, like a partner or joint venture party even though the contracts say it is expressly not." Consequently, the court held that the MSAs "involve relationships of personal trust in which the character, reputation, skill and discretion of [the debtor] is necessary to render performance" and were therefore barred from assignment under Section 365(c)(1). In other words, the court held that the MSAs were or similar to personal service contracts.

Distinguishing *IntegraMed*

At first blush, the *IntegraMed* ruling appears to be problematic for private equity firms and lenders making equity and debt investments, respectively, in MSO structures. The court did not elaborate on how it might analyze other MSAs in MSO structures. Any general proposition that MSAs cannot be freely assigned in a bankruptcy sale would eliminate one restructuring approach lenders rely on when planning for a downside case in underwriting. But certain aspects of the IntegraMed business distinguish it from the comprehensive MSO structures, which likely mitigate concern stemming from the *IntegraMed* ruling.

First, the IntegraMed business model appeared to resemble a vendor-like MSO structure. The medical practices subject to vendor-like MSO structures are owned by one or more physicians who are not subject to STRAs and, in a distressed scenario, often seek to repurchase their practice or otherwise terminate the MSAs. In contrast, comprehensive MSO structures greatly reduce the risk that physician owners will attempt to terminate the MSA or object to an assignment of the MSA to a third party because the MSO (and, derivatively pursuant to the collateral assignment of the MSA and STRA, a lender) may remove and replace the physicians that own the practice. Furthermore, it is customary for the existing physician owners to also be granted equity in the MSO under comprehensive MSO structures, which naturally yields an alignment of interests between the existing physician owners and the MSO.

Second, all but one of the IntegraMed MSAs at issue prohibited assignment. Although it is unclear from the ruling what impact, if any, that fact had on the court's ruling, free assignability is a standard feature of MSAs under comprehensive MSO structures and one that lenders generally require in MSO financings. At a minimum, assignment provisions of MSAs and STRAs should clearly permit assignment. Going forward, it would be advisable in the wake of the *IntegraMed* ruling to bolster the assignment provisions to expressly acknowledge that (1) the assignability is intended to apply to a sale under Section 363 of the Bankruptcy Code; and (2) the contracting parties do not intend such agreements to be considered personal service contracts under Section 365(c).

Third, the court's ruling reflects that the trustee submitted very little evidence to support his contention that the IntegraMed MSAs were not personal service contracts. Nor did the court have a record it could rely on to understand the market impact of MSAs: "I had no testimony on the way management services agreements work in the medical field; although, it was at least suggested that some type of management service agreement is common in the medical industry. And putting these agreements in context I can, however, draw somewhat from my own experience." These are important contextual details that may help distinguish *IntegraMed* for future litigants. Armed with testimony, declarations, and perhaps expert testimony for how MSAs are critical to MSOs and the financing of these structures, future courts may limit Section 365(c)(1) in MSAs to its normally narrow interpretation.

Fourth, the court stated that the "equal voice in management of the medical practice [*sic*] imbues the management company with the ability to control, through its persuasive powers or by obstruction, the destiny of the practice making the management company, in essence, like a partner or joint venture party even though the contracts say it is expressly not." In many comprehensive MSO structures, the MSO may have the right to participate on physician advisory committees or policy boards and effectively have a seat at the table to deliberate and assist the medical practice in making strategic decisions affecting the medical practice, including decisions about budgets, expansion, capital expenditures, long-term strategic plans, and recommendations on recruiting and staffing. The court noted that IntegraMed, through its participation in the practice management board, had "an equal voice in all or virtually all of the non-medical aspects of the medical practices." The court's ruling would appear to find that participation in the medical practice's decision-making can position the MSO in the role of a partner whose "singular judgment" and "discretion"—as cited by the court—rise to the level of a partner providing personal services to the medical practice. These details and IntegraMed's role in the practice management board may be distinguished from other MSO arrangements. Following the court ruling, MSOs with participation in practice management boards should revisit participation in any formal advisory committees or policy-making boards of medical practices. Similarly, MSOs should consider whether any power-of-attorney or similar rights in favor of the MSO give the MSO the ability to obstruct the operations of the medical practice.

The court's ruling has not yet been appealed. The private equity community, lenders, and health care restructuring advisors are paying close attention to this ruling (and the outcome of any appeal) due to the potential impact on availability of credit, valuations, and restructuring strategy.

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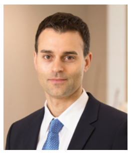

Michael G. Parisi
404.881.4779
mike.parisi@alston.com

Jonathan T. Edwards
404.881.4985
212.905.9126
jonathan.edwards@alston.com

Adam R. Monich
404.881.7830
adam.monich@alston.com

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WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86.10.85927500
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: Chase Tower ▪ 2200 Ross Avenue ▪ Suite 2300 ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LONDON: 5th Floor ▪ Octagon Point, St. Paul's ▪ 5 Cheapside ▪ London, EC2V 6AA, UK ▪ +44.0.20.3823.2225
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ▪ Suite 600 ▪ Raleigh, North Carolina, USA, 27601-3034 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001
SILICON VALLEY: 950 Page Mill Road ▪ Palo Alto, California, USA 94304-1012 ▪ 650.838.2000 ▪ Fax: 650.838.2001
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