

Security Interests: Health-Care-Insurance Receivables

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A discussion on health-care-insurance receivables and the methods of perfection of a security interest in them under the UCC. This Note also examines the issues that arise relating to health-care-insurance receivables paid by the government.

Providing a secured credit facility to a borrower whose primary customer is the federal government creates numerous challenges, including the lender's performance of due diligence and the perfection of its security interest in the borrower's collateral. These challenges are compounded further if the borrower's industry is healthcare. In the debt markets, the healthcare industry is a broad designation that can encompass various healthcare providers, including, without limitation, hospitals, medical device manufacturers, medical laboratories, physician practices, home hospice companies and skilled nursing facilities.

This Note discusses the issues and potential solutions for lenders to healthcare companies, with a particular focus on taking a perfected security interest in health-care-insurance receivables as defined in the Uniform Commercial Code (UCC).

Due Diligence in Healthcare Financings

While attorneys should review several matters when advising a lender in a healthcare financing transaction, they should primarily focus on the borrower's compliance with state and federal statutes, regulations and compliance programs.

A good starting point is to review the compliance programs set out by the Office of Inspector General (OIG) as part of the US Department of Health & Human Services. The OIG has issued compliance guidelines for different types of companies that fall under the umbrella of the healthcare industry. Failure to comply with the minimum compliance standards set out by the OIG may prohibit the healthcare company from participating in

federal healthcare programs (such as Medicaid and Medicare). In addition to general compliance issues, the lender should focus its due diligence of the borrower on:

- Proper licensing.
- Proper medical coding practices.
- Proper federal and state government reporting.
- Fraud and abuse (anti-kickback statutes).
- Product liability issues.
- Confidentiality.
- Intellectual property matters.
- Health Insurance Portability and Accountability Act of 1996 (HIPAA) compliance.

There will be additional issues if the financing also involves an acquisition (for example, if the acquisition constitutes a change of ownership). For more information on healthcare transaction due diligence, see [Practice Note, Acquiring Pharmaceutical or Medical Device Manufacturers](#) and for more information on general finance due diligence, see [Practice Note, Due Diligence: Lending](#).

Special healthcare counsel may be needed to advise lenders on the issues and regulatory risks involved with healthcare financing deals. The lender should also be aware of any issues with the remedies available to it if the deal sours.

Collateral

When providing financing to a healthcare company, a lender should focus on what type of collateral is available to secure its loan. Healthcare companies generally pledge



some or substantially all of their assets as collateral. With the exception of a medical device or pharmaceutical company that may own valuable intellectual property, typically the primary assets of most healthcare companies consist of a combination of real property, accounts receivable and inventory. There may also be other related collateral such as books and records, licenses, provider agreements and proceeds.

A security interest must be created and have attached to the collateral for the lender to have a valid security interest. The relevant entities should enter into a security agreement granting a security interest over the collateral in favor of the lender. When preparing the security documents, the lender should consider:

- The identity of the healthcare provider.
- The company structure.
- Who owns the collateral.
- Who is entitled to payment on the accounts receivable.

Once a security interest is created and attached, the lender can enforce its security interest in the collateral against the debtor. To enforce its security interest in the collateral against third parties, a lender must perfect its security interest. For more information about security interests, see [Practice Note, UCC Creation, Perfection, and Priority of Security Interests](#).

A security interest in real property and in inventory can be perfected in a straightforward manner. Perfecting in real property requires a mortgage or deed of trust to be signed by the healthcare provider debtor and the lender and then filed in the county where the real property is located. A security interest in inventory can be perfected by filing a properly completed UCC-1 financing statement (UCC-1) in the appropriate filing office. In a typical secured loan transaction, the lender would perfect its security interest in the healthcare provider debtor's accounts receivable by filing a UCC-1. It becomes a bit more complicated, however, when it comes to perfecting a security interest in the accounts receivable for a healthcare company.

What are Health-Care-Insurance Receivables?

Under the UCC, health-care-insurance receivables are a subset of accounts. Section 9-102(46) of the UCC defines health-care-insurance receivables as "an interest in or claim under a policy of insurance which is a right to payment of a monetary obligation for health-care goods or services provided." As part of its due diligence, the lender

should find out the identity of the payors of the accounts receivable. The two main types of health-care-insurance receivables are private paid and government paid.

Private paid health-care-insurance receivables refer to the right of a healthcare provider debtor to receive a payment from a private insurance company. These insurance companies are often made available to individual customers through a private employer.

Government paid health-care-insurance receivables refer to the right of a healthcare provider debtor to receive a payment from a federal or state government through programs such as Medicare, Medicaid or Tricare.

Medicare is the government financed healthcare insurance program for individuals that are 65 and older administered by The Secretary of Health and Human Services through the Center for Medicare and Medicaid Services (CMS). Because the federal government does not have the systems in place to operate an insurance reimbursement program, CMS contracts with private insurance companies to act as the intermediary between patients, healthcare providers and the government.

Medicaid, a program under the Social Security Act, provides federal and state financial assistance to individuals based on financial need.

Tricare, an insurance program for military personnel, also comes under the supervision of CMS.

Perfection of a Security Interest in Health-Care-Insurance Receivables

A security interest in health-care-insurance receivables is perfected through the filing of a UCC-1. When the account debtor (the private insurance company or the government) pays the healthcare provider, however, the lender's collateral changes form from a receivable into cash proceeds which are then deposited into a company account. A secured lender may also seek to perfect its security interest in the actual deposit account where the cash proceeds from the health-care insurance receivables are deposited. Note, here, the distinction between a security interest in the deposit account as **original collateral** and a security interest in the deposit account where the **proceeds** of the health-care-insurance receivables are deposited.

A security interest attaches to the cash proceeds of a health-care-insurance receivable at the moment the healthcare provider debtor receives payment. It is not necessary for the lender to have control of the healthcare

provider debtor's account to perfect its security interest in the cash proceeds of health-care-insurance receivables, as the UCC provides for temporary perfection of proceeds of collateral (UCC § 9-315(c)). After 21 days, however, the lender's security interest in the cash proceeds becomes unperfected unless the cash proceeds are "identifiable" (UCC § 9-315(d)(2)). In other words, the cash proceeds cannot be commingled with any other funds.

Consequently, the lender should require the healthcare provider debtor to deposit all of the proceeds from health-care-insurance receivables into two separate deposit accounts, a government paid receivables account and a private paid receivables account. Creating a segregated account to hold the government paid health-care-insurance receivables also allows the lender to easily trace and identify the cash proceeds.

Private Paid Health-Care-Insurance Receivables

To perfect in a deposit account, the lender must have control of the deposit account. Control under the UCC is typically obtained in one of three ways:

- First, the lender can be the healthcare provider debtor's depository bank for its bank accounts (UCC § 9-104(a)(1)).
- Second, the lender can enter into a deposit account control agreement with the healthcare provider debtor and the depository bank (UCC § 9-104(a)(2)).
- Third, the lender becomes the depository bank's customer with respect to that specific deposit account (UCC § 9-104(a)(3)). In other words, the name on the account is changed from the healthcare provider debtor's to the lender's, which then deprives the debtor of the ability to make transactions involving that account. This method is the best level of perfection and is also known as "super control."

Note, however, that although it is effective, super control is a rarely used method of control. In addition, a healthcare provider debtor is often unwilling to switch the location of its deposit accounts to accommodate the lender's desire to perfect its security interest, especially when the healthcare provider debtor has an established banking relationship with a particular depository institution. Therefore, deposit account control agreements are the most utilized form of perfection, as they are often the most painless for both the lender and the healthcare provider debtor.

To the extent the lender has filed a proper UCC-1 and obtained control over the deposit account, the lender will

then have a perfected security interest in the health-care-insurance receivable itself as well as the cash proceeds when the account is actually paid to the healthcare provider debtor.

For more information on security interests in deposit accounts, see [Practice Note, Security Interests: Deposit Accounts](#).

Government Paid Health-Care-Insurance Receivables

Perfecting government paid health-care-insurance receivables follows a similar process but with some additional layers of complexity. Under the UCC, health-care-insurance receivables are perfected by the filing of a UCC-1. However, unlike private paid health-care-insurance receivables, the anti-assignment provisions of Medicare and Medicaid statutes prohibit a lender from taking control of the deposit account in which Medicare and Medicaid health-care-insurance receivables are deposited. The anti-assignment provisions were introduced in the 1970s in an attempt to prevent third parties (for example, factoring arrangement providers and collection agencies) from making fraudulent or excessive claims against the government.

In the current landscape, the CMS issues a provider number to a healthcare company. Once the company has a provider number, government health-care-insurance receivables are then paid into a deposit account of that company. Further, only the company with that provider number is permitted to receive payments in that deposit account and give any instructions concerning that deposit account.

Despite the fact that Section 9-408 of the UCC clearly permits the security interest to be granted as well as allows traditional remedies on those receivables, the doctrine of preemption requires that federal law govern the government receivables. Because of the issues with government receivables, the proceeds from private paid receivables should not be commingled in the same account with the proceeds of government paid receivables.

While the anti-assignment provisions of Medicare and Medicaid do not cause any perfection issues regarding the health-care-insurance receivables themselves, they do impact a lender's ability to realize the full collateral benefit from those receivables (see [Strategies to Enhance Security Interests in Government Paid Health-Care-Insurance Receivables](#)).

Strategies to Enhance Security Interests in Government Paid Health-Care-Insurance Receivables

Because of the government restrictions in place, lenders face two issues when trying to realize on health-care-insurance receivables:

- A lender is not permitted to take control of the healthcare provider debtor's deposit account that receives government paid health-care-insurance receivables (see Government Paid Health-Care-Insurance Receivables).
- To the extent a lender forecloses on the security interest in the health-care-insurance receivables, the lender does not have the ability to:
 - receive payments on the government paid health-care-insurance receivables; or
 - direct the government to make payments to the lender.

However, lenders can take certain steps to maximize the value of their security interest in health-care-insurance receivables.

Double Lockbox Arrangements

A lender must use a double lockbox arrangement to maximize the value of its security interest because:

- A lender is not permitted to have control of a healthcare provider debtor's deposit account if that account receives the proceeds of government paid health-care-insurance receivables.
- The deposit account must be in the name of the healthcare provider debtor.

In lieu of a deposit account control agreement, the lender must enter into a deposit account instruction agreement with the depository bank and the healthcare provider debtor. This agreement directs the depository bank to sweep the proceeds paid by the government to a separate account governed by a traditional deposit account control agreement.

The deposit account instruction agreement must clearly specify that the healthcare provider debtor retains the ultimate right to direct the disposition of funds in the government receivables deposit account. As a result, the lender's collateral remains at risk because the healthcare provider debtor maintains control of the deposit account and can rescind the sweep order at any time. To minimize this risk, a secured lender should insist on a daily sweep of

the healthcare provider debtor's government paid health-care-insurance receivables deposit account.

A healthcare credit agreement would typically include a covenant that all of the healthcare provider debtor's accounts (other than any specifically excluded accounts) be subject to either a deposit account control agreement or, with respect to government-paid health-care-insurance receivables, a deposit account instruction agreement. Furthermore, these credit agreements often contain an event of default that provides that if there should occur, without the written consent of the lender, any rescission, revocation or modification of any instruction or agreement regarding the account into which the proceeds are paid or the sweep instructions relating thereto, an immediate event of default would occur under the credit agreement.

Lenders must also be aware that if a bankruptcy event occurs:

- The sweep may no longer be permitted.
- Funds may become trapped in the account in which the lender does not have control under the UCC.

Credit Agreement

All credit agreements have representations and warranties and covenants regarding:

- Compliance with laws.
- Providing collateral.
- The incurrence of additional debt and liens.

Most credit agreements have general compliance with laws representations and covenants, each of which may be subject to a material adverse effect standard.

In addition to these standard representations, warranties and covenants, a lender should insist on additional, tighter representations and covenants regarding compliance with healthcare laws. This is done to ensure that the healthcare provider debtor, secured lender and depository bank strictly comply with:

- HIPAA.
- The Social Security Act.
- Anti-kickback statutes.
- Medicare and Medicaid regulations.

Noncompliance may result in severe ramifications to the healthcare provider debtor. For example, if a lender obtained control of a government paid health-care-insurance receivables deposit account, the provider

agreement between Medicare and the healthcare provider is subject to termination.

Credit agreements should also contain strict representations, warranties and covenants that address the healthcare provider debtor's compliance with:

- Licensing.
- Accreditation.
- Government reimbursement programs.
- Reporting and billing requirements.

For an example credit agreement that includes healthcare provisions, see PLC What's Market MEDNAX, Inc. Credit Agreement Summary.

Because perfection of government paid health-care-insurance receivables is not as straightforward as perfection of private paid health-care-insurance receivables, the credit agreement should also contain covenants that limit the amount of other debt (including secured debt) and other liens that the healthcare provider debtor may incur.

Legal Opinions

Legal Opinions Concerning Health-Care-Insurance Receivables

While the UCC clearly permits a security interest to be granted in health-care-insurance receivables, it does not differentiate between government paid and private paid health-care-insurance receivables. As a result, when closing a credit facility, the healthcare provider debtor's legal counsel should be able to provide the lender with a perfection opinion regarding health-care-insurance receivables.

For government paid health-care-insurance receivables, however, the legal opinion will most likely have a carve-out or exception regarding the lender's enforcement of remedies. A traditional opinion exception would read:

"We express no opinion as to the enforceability, as against the government of the United States of America or any state thereof, of any assignment or security interest in any Collateral constituting accounts or other claims against the government of the United States of America subject to the Federal Assignment of Claims Act or other statutes or regulations restricting or prohibiting such assignments or security interests, or against any such state subject to similar laws or regulations restricting or prohibiting assignment of government claims."

Any "remedies opinion" given for government paid health-care-insurance receivables would most likely

state that the lender must seek a court order before it is allowed to exercise its rights under the UCC. The result is that the lender then lacks an affirmative statement in the opinion concerning the general availability of remedies.

Legal Opinions Concerning Deposit Accounts as Original Collateral

For a legal opinion concerning a perfected security interest in the healthcare provider debtor's deposit account as original collateral, the opinion giver must determine whether or not the applicable standards for achieving control of the deposit account are met. A standard opinion on the perfection of a security interest in a deposit account, as original collateral, would state that the security interest in the deposit account is perfected on the execution and delivery by the debtor, the secured lender and the depository bank of a legally sufficient deposit account control agreement. This type of opinion cannot be rendered for a deposit account instruction agreement because this agreement does not provide the lender with control as required by the UCC.

Legal Opinions Concerning Deposit Account Instruction Agreements

The legal counsel for a healthcare provider debtor may be reluctant to give an opinion on the deposit account instruction agreement. The agreement does not create any type of security interest and the healthcare provider debtor has the ability to terminate the agreement or alter the sweep mechanics at its discretion. As a result, the agreement itself does not provide the lender with the same protections as the credit agreement or other security documents. To the extent an opinion is given on the deposit account instruction agreement, it will most likely be limited to enforceability only and no opinion will be given on available remedies.

Healthcare Provider Debtors Need Strict Guidance

Despite some of the unique collateral issues, lending to healthcare companies is commonplace in the market. In the acquisition context, lenders must engage in substantial due diligence to ensure the target company is:

- Complying with state and federal healthcare laws.
- Operating in a fashion that allows them to collect their health-care-insurance receivables in a customary time period.

Security Interests: Health-Care-Insurance Receivables

On a going-forward basis, credit agreements should provide strict guidance for healthcare provider debtors so that they continue to comply with the government regulations allowing them to operate and collect on health-care-insurance receivables. Because perfection of government paid health-care-insurance receivables is not as iron-clad as other types of collateral, lenders should also determine what value (or discount) should apply to the collateral that consists of government paid health-care-insurance receivables. This would apply both in the context of asset-based lending with respect to the

calculation of the borrowing base and in the context of cash-flow lending with respect to certain matters, for example, the calculation of the amount of the healthcare provider debtor's collateral available to secure the loan, applicable pricing and financial covenants.

While not ideal, the combination of the UCC perfection provisions, the terms of the credit agreement, the double lockbox arrangement and a substantive legal opinion should provide a lender with some comfort regarding their security interest in health-care-insurance receivables.

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