

INITIAL ENTRANCE DEPOSITS IN TROUBLED CCRCs

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Continuing care retirement communities (CCRCs), which provide seniors with the ability to remain within the same community for the remainder of their years and the peace of mind that comes along with such stability, have become increasingly popular over the past few decades. Under one popular business model, prior to moving into a CCRC, a senior typically pays a sizable initial entrance deposit (an IED).ⁱ

The IEDs, in turn, provide the cash flow necessary to operate the CCRC and to pay down the significant debt used to fund the construction of the CCRC. The resident retains a right to receive a refund of the IED when the resident dies and/or their unit is resold. Because payment of an IED is often linked to the sale of a senior's home, the success of a CCRC depends greatly on the housing market. Stress in the housing market has slowed the pace of "absorption" at many CCRCs resulting in defaults and bankruptcy filings which have placed residents' interests in jeopardy. Resident's interests in IEDs are at risk because the project's contingent obligation to refund the IEDs is subordinate in fact to the secured debt which funded the project's construction. The treatment of IEDs and residency agreements after a CCRC is in danger of defaulting on its secured loans has become a hot-button issue which creates great concern among regulators,ⁱⁱ current and potential residents of a bankrupt CCRC and may impact the post-bankruptcy success of the CCRC.

The resident's IED is usually a substantial portion of the amount received from the sale of their previous residence and the vast majority of the amount they plan on leaving to their loved ones. IEDs are often reimbursable, in whole or in part, upon the death of the resident or termination of occupancy of the unit by the resident. Such reimbursement, however, is frequently conditioned upon the reoccupancy of the unit by a new resident and payment of a replacement entrance deposit. Many residency agreements are silent as to the disposition of the IEDs when the CCRC files for bankruptcy or closes, however they make it clear that the repayment of the IED does not create any security interest.ⁱⁱⁱ

As important as IEDs are to the residents, they are similarly important to the operations of the CCRCs. The influx of IEDs is the lifeblood of a CCRC, which require IEDs to pay down their debt or fund operations. Over the past several years, as housing prices have fallen, seniors have lost the ability to sell their homes and

pay the sizeable IEDs. This, in turn, resulted in financial difficulties for CCRCs and, in fact, several CCRCs have filed for bankruptcy or restructured their debt out-of-court.

Once a CCRC is near default on its secured loans, management is faced with many of the same issues as other management of an entity in the “zone of insolvency,”^{iv} however, CCRCs present sensitive issues that are unique to their industry and residents. If a CCRC cannot keep its current residents or attract new residents, it will be deprived of its primary source of revenue, the IEDs, and will have a difficult time operating its business and may be forced to liquidate in the face of secured creditors that are vastly undersecured. Management who accepts IEDs after it knows the CCRC is in or close to a default may be held liable for negligently making misrepresentations to residents.^v Therefore, CCRCs that wish to continue operations or sell their assets as a going concern must assure current and potential residents that the CCRC’s bankruptcy case will not put their IEDs at risk.

The Covenant at South Hills, Inc. Case

The bankruptcy case of The Covenant at South Hills, Inc. (Covenant) sent shockwaves through the CCRC community when the sale of Covenant’s assets did not include the assumption of the liabilities related to refunding the residents’ IEDs. On September 18, 2009, the Bankruptcy Court for the Western District of Pennsylvania approved the sale of the assets of Covenant to Concordia Lutheran Ministries (Concordia) for \$15 million plus certain assumed liabilities.^{vi} The asset purchase agreement, however, explicitly stated that the Purchaser was not assuming obligations to residents, but offering new arrangements post-sale.^{vii} Concordia permitted the residents to continue to live at the CCRC if they entered into an agreement to modify their residency agreement which, among other things, stripped the residency agreement of any and all references to the refund of any portion of the resident’s IED.^{viii} According to the residents’ estimates, the amount of the IEDs not returned was approximately \$20-23 million.^{ix} Representatives of the creditors and residents filed a motion to require Covenant to honor the residency agreements. The Bankruptcy Court ultimately entered an order deeming the residency agreements as rejected (which amounts to a breach of such agreements and effectively terminates all responsibilities Covenant had to the residents) providing the residents with unsecured rejection damages.^x Given the amount of secured debt (approximately \$50 million), the residents likely will not receive any distribution.

After the sale of Covenant, a group of residents filed several suits against the not-for-profit company that owned the Covenant CCRC, certain directors thereof, Covenant’s development company and Covenant’s management company for, among other things, fraud and negligent misrepresentation in entering into the residency agreements.^{xi} Among the misrepresentations alleged was that the IEDs would be “safe” or held in escrow, the CCRC would act as a surety or be responsible for the safekeeping of the IEDs and the CCRC would perform the obligations under the residency agreements.^{xii} After contentious litigation, the parties have agreed upon the monetary terms of an undisclosed settlement but the settlement has yet to be presented to the court, however the court has granted a motion to maintain all settlement documents under seal.^{xiii}

The fate of the residents of the Covenant CCRC has made national news and has been part of a congressional inquiry into regulations regarding CCRCs.^{xiv} In CCRC bankruptcy cases subsequent to the *Covenant* case, residents, state regulators and state attorneys general have been deeply involved in order to prevent the situation that occurred at Covenant and protect seniors that have invested what often amounts to their life savings into a CCRC to permit them to live there for the remainder of their years. Seniors, on the other hand, have been reluctant to enter into residency agreements with bankrupt CCRCs or CCRCs that may appear to be in distress.

Erickson Retirement Communities, LLC Case

In the bankruptcy cases of Erickson Retirement Communities, LLC and its affiliates (collectively, "*Erickson*"), Erickson worked closely with state regulators to determine what level of protection was necessary in order to ease the fears of the residents and comply with any applicable state regulations. After lengthy prepetition conversations with state regulators, one day after the filing of their bankruptcy petitions, Erickson, to provide assurance to new residents that the bankruptcy cases will not affect their right to a refund, filed a motion to escrow the IEDs collected after the bankruptcy filing.^{xv} Shortly thereafter, Erickson filed a second motion to, among other things, (i) amend the residency agreements with an addendum providing that if a resident ceases to reside in his or her respective CCRC and complies with all the requirements set forth in his or her residency agreement, without the necessity of a new resident occupying the departing resident's unit, the resident shall be entitled to a refund of their IEDs, to the extent deposited in an escrow account, during the pendency of Erickson's chapter 11 case; and (ii) require the return of the escrowed IEDs upon the closure of any of Erickson's CCRCs.^{xvi} Both of the motions regarding IEDs were granted by the Bankruptcy Court for the Northern District of Texas.

Ultimately, Erickson's assets were sold, pursuant to a plan of reorganization which included the assumption of the residency agreements in their entirety and each of the CCRCs continued to operate. As a result of the structure of the sale of Erickson's assets, the residency agreements remained in place, the IEDs were unaffected during and after Erickson's bankruptcy case, management was protected from any potential liability and the secured creditors were able to receive the highest possible amount for their collateral.

Lincolnshire Campus, LLC Case

In the chapter 11 cases of Lincolnshire Campus, LLC and Naperville Campus, LLC, two subsidiaries of Erickson, as well as their related not-for-profit entities (collectively, the Lincolnshire Debtors), the Lincolnshire Debtors, after discussions with state regulators, filed a motion three days after the bankruptcy filing to, among other things, (i) escrow the IEDs collected after the petition date, (ii) amend the residency agreements with an addendum providing that if a resident ceases to reside in his or her respective CCRC and complies with all the requirements set forth in his or her residency agreement, without the necessity of a new resident occupying the departing resident's unit, the resident shall be entitled to a refund of their IEDs during the pendency of the Lincolnshire Debtors' chapter 11 case, to the extent deposited in an escrow account, and (iii) require the return of the escrowed IEDs upon the closure

of any of the Lincolnshire Debtors' CCRCs.^{xvii} This motion was granted by the Bankruptcy Court.

In a further showing of its commitment to protect the value of their estates and their residents, as part of the bidding procedures for the sale of substantially all of their assets, the Lincolnshire Debtors made it a requirement of all bids to provide that "the Potential Bidder takes assignment of, and agrees to honor, all terms of the Residence and Care Agreements for each of the residents of the Debtors' facilities, including but not limited to the right of each such resident to the refund of their entrance deposit in accordance with the terms of such applicable Residence and Care Agreement."^{xviii} Ultimately, the Lincolnshire Debtors sold substantially all of their assets as part of a sale pursuant to section 363 of the Bankruptcy Code and each of the CCRCs continued to operate. Accordingly, each of the residency agreements remained in place and all IEDs were unaffected during and after Lincolnshire Debtors' bankruptcy cases.

Out of Court Restructurings

Because bankruptcy filings are extremely disruptive to the residents, employees and management of CCRCs, many CCRCs have attempted to restructure their debt out of court. In these out of court restructurings, the terms of the underlying debt are typically renegotiated prior to or shortly after the CCRC defaults under the loan documents. Out of court transactions provide the CCRC with "breathing room" similar to a bankruptcy proceeding, however there is no disruption to the residents of the CCRC, the obligations arising under the residency agreements remain untouched and the IEDs are not put at risk. While out of court restructurings may be consummated more quickly and without disrupting certain constituencies, many CCRCs are unable to avoid a bankruptcy filing because the CCRC may wish to avail itself of certain protections provided by the Bankruptcy Code and out of court restructurings lack the finality that a bankruptcy court order provides.

Conclusion

The influx of new IEDs is necessary for the operation of any CCRC and it is imperative that residents know that their IEDs are protected in order to persuade them to enter into residency agreements with CCRCs and hand over what often amounts to their life savings. Once a CCRC is in default or files for bankruptcy, management is put in a very difficult situation and it becomes more difficult to put current and potential residents at ease that their IEDs will be protected, a problem exacerbated by the *Covenant* case. The success of Erickson and the Lincolnshire Debtors, which sold their businesses while continuing operations, protecting management and serving their elderly residents, is directly attributable to the speed at which they exited bankruptcy, communication with the respective resident committees and state regulators and the favorable treatment of the residents' IEDs. As was shown by Erickson and the Lincolnshire Debtors, it is in the best interests of the debtors, their estates, creditors and even potential purchasers that CCRC debtors treat their residents, although a minor constituency in bankruptcy terms, with the utmost respect and do everything in their power to support the residents' needs and comply with applicable state regulations, especially if the debtors plan on entering into a going concern sale of their assets. Accordingly, all future CCRC

debtors should seriously consider adopting the Erickson/Lincolnshire model of protecting IEDs.

ⁱ Additionally, residents pay monthly fees that vary depending on the services provided by each CCRC.

ⁱⁱ See S. SPECIAL. COMM. ON AGING, *Continuing Care Retirement Communities: Risks to Seniors* (Comm. Print 2010), at 5-6.

ⁱⁱⁱ *Id.*

^{iv} See, generally, Jane Lee Vris, et al., *Duties of Directors and Officers of Distressed Companies*, 927 PLI/Comm 395, PRACTICING LAW INSTITUTE COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES (Apr. 19-20, 2010)

^v See Amended Class Action Complaint, *Hirschfield, et al. v. B'Nai B'Rith International, et al.*, Case No. 09-01535 (W.D. Penn. May 30, 2009); Amended Class Action Complaint, *Hartman, et al. v. Levin, et al.*, Case No. 10-00029 (W.D. Penn. Apr. 30, 2010).

^{vi} See Order Approving Sale Free and Clear, *In re The Covenant at South Hills, Inc.*, Case No. 09-20121 (JKF) (Bankr. W.D. Penn. Sept. 18, 2009).

^{vii} APA section 4.6

^{viii} Exhibit 4.6 to the APA.

^{ix} See Motion of the Official Committee of Unsecured Creditors and The Covenant at South Hills Independent Living Residents' Council for an Order Requiring the Debtor to Determine Whether to Assume or Reject Residency Agreements, *Covenant at South Hills* (Bankr. W.D. Penn. Sept. 21, 2009).

^x See Order Requiring the Debtor to Determine Whether to Assume or Reject Residency Agreements, *Covenant at South Hills* (Bankr. W.D. Penn. Oct. 30, 2009).

^{xi} See Amended Class Action Complaint, *Hirschfield, et al. v. B'Nai B'Rith International, et al.*, Case No. 09-01535 (W.D. Penn. May 30, 2009); Amended Class Action Complaint, *Hartman, et al. v. Levin, et al.*, Case No. 10-00029 (W.D. Penn. Apr. 30, 2010).

^{xii} *Id.*

^{xiii} See Joint Status Report, *Hirschfield*, Case No. 09-01535 (W.D. Penn. Jan. 3, 2011); Order Granting Motion to Maintain Settlement Documents Under Seal, *Hirschfield*, Case No. 09-01535 (W.D. Penn. Mar. 17, 2011).

^{xiv} Linda Stern, *Bankruptcies Hit Retirement Communities: Elderly Residents Who Thought They'd Secured Their Futures Are Finding Their Homes and Savings At Risk*, NEWSWEEK, Nov. 24, 2009; David S. Hilzenrath, *You're Only As Secure As the Retirement Home*, WASH. POST, Oct. 31, 2009; Kelly Greene, *Continuing-Care Retirement Communities: Weighing the Risks*, WALL ST. J., Aug. 7, 2010; U.S. Government Accountability Office, *Older Americans: Continuing Care Retirement Communities Can Provide Benefits, But Not Without Some Risk*, GAO-10-611 (2010).

^{xv} See Motion for an Order Authorizing Debtors to Escrow Initial Entrance Deposits, *In re Erickson Retirement Communities, LLC*, Case No. 09-37010 (Bankr. N.D. Tex. Oct. 20, 2009).

^{xvi} See Motion For An Order Authorizing Additional Protections to Residents' Initial Entrance Deposits, *Erickson*, Case No. 09-37010 (Bankr. N.D. Tex. Nov. 11, 2009).

^{xvii} See Motion For An Order Authorizing Debtor to Escrow Initial Entrance Deposits, *In re Lincolnshire Campus, LLC*, Case No. 10-31476 (Bankr. N.D. Tex. June 18, 2010).

^{xviii} See Notice of Revised Bid Procedures, *Lincolnshire*, Case No. 10-31476 (Bankr. N.D. Tex. Sept. 8, 2010).