

Getting Rid of Bad Debt Blues

Another Option When Managing Receivables



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Of any industry's financial operations, those of a hospital are some of the most complicated. Reimbursement rules, third-party contracts, and costing supplies and services are all part of the complex nature of the game. Yet there's one financial concept that is pretty simple no matter the industry: Money now is better than money later.

Unfortunately, when it comes to healthcare receivables, money later—if at all—is more and more often the case. According to the American Hospital Association, uncompensated care (including bad debt and charity) cost U.S. hospitals \$31.2 billion in 2006, representing 5.7 percent of annual hospital expenses, and an 8 percent increase from uncompensated care costs in 2005.¹ And the problem is only expected to worsen.

The growing uninsured population, as well as increases in deductibles, co-pays, and co-insurance among policyholders are the primary causes for the increase in bad debt and why it's likely to continue to grow as healthcare costs continue to shift to the consumer, according to Fitch Ratings, which saw bad debt expense and accounts receivable reserving methodologies as one of the most important issues for for-profit hospitals in 2007.²

As financial pressures continue to build and bad debt becomes harder to simply write off, hospitals are looking for alternatives to the traditional, and increasingly insufficient, ways of collecting on their aged receivables.

"Today, hospital CEOs and CFOs across the country are struggling with what is absolutely a daunting challenge," says Carl Reyes, executive vice president of Equicare Capital, Inc., a Dallas-based healthcare receivables management firm. "In a world where self-pay receivables are rising at an unprecedented rate, third-party payment is on the decline, operating expenses are on the rise, and human resources continue to be spread thin, how do they continue to service the community that they have an obligation to? Most hospitals are struggling with that right now."

■ Managing Receivables

Traditionally, hospitals have handled their receivables internally and then turned them over to collections agencies after 120 days. More recently, hospitals have begun to review their point-of-collection processes to see where improvement could be made on the front end. This often results in a more skilled front-end worker who can handle complex computer systems and understands the importance of collecting accurate information at the time the patient registers.

At the other end, some hospitals are even using multiple tiers of collections agencies to collect on those accounts that a primary agency doesn't. One of these hospitals is Mount Carmel Health, a four-hospital system in Columbus, Ohio, that is owned by Trinity Health of Novi, Mich. Nearly two years ago, Mount Carmel began evaluating what to do with its growing amount of bad debt. The hospital had been using a collection agency for its aged receivables, but found that the collection rate was running at less than 10 percent. "That bothered us. We didn't see a big return," says Karen Geisler, vice president of patient financial services for Mount Carmel.

So the health system decided to implement a tiered collections strategy. An account in which the patient is not eligible for charity care and has no insurance is transferred to a primary collections agency after 90 days. If the patient has insurance, the account is transferred to the primary agency about 90 days after the start of the health system's internal self-pay collections process. The primary agency works on the accounts for 180 days. After that, uncollected accounts are transferred to a second agency, which holds them for 365 days. The accounts then are placed with a third agency, which keeps them for as long as the statute of limitations in Ohio allows, Geisler explains.

The hospital also beefed up its internal processes by identifying more accounts as charity and doing a better job of collection at point of service. The hospital's rate of collection with its agencies has remained stable, but it is sending fewer accounts to collections. "We've seen an improvement in the dollars that we're collecting ourselves, especially at point of service," Geisler says.

For many hospitals, however, these internal and external efforts often come up short. Although the hospital may eventually collect on these aged receivables, in the end it may have extended a significant amount of resources to reach that point. The question then becomes: Is the amount of time and money devoted to the collections process worth it?

For more and more hospitals, the answer is “No, it’s not worth it.” For the most part, hospitals first will use their internal resources toward collecting accounts with the largest balances, often totaling hundreds of thousands of dollars. Typically, they do not have the staff to dedicate time to collecting smaller accounts of less than a few thousand dollars. Nor are hospitals generally skilled at managing external collections agencies.

Realizing their own lack of resources and expertise, these hospitals have begun to consider another option that other industries, such as the credit card industry, have been using for years: selling bad debt. Estimates of the amount of aged healthcare debt available to be serviced or sold range from \$25 billion to in excess of \$150 billion, making it very clear why hospitals can no longer set aside these receivables.³

“The volume of healthcare receivables in the United States literally dwarfs the volume of credit card receivables out there, so it’s a large asset class,” says Reyes. “And I think everybody would agree that hospitals just do not have the resources, technology, and experience that credit card companies have in maximizing the return from their bad debt portfolios.”

Ins and Outs of Selling Receivables

When a hospital sells its debt, the aged accounts are sold to the buyer outright. The hospital receives the cash immediately. The chief benefit to the hospital is in the acceleration of cash, so it doesn’t have to wait over the period of time for the collection agency to extract.

In short: The hospital furnishes the buyer with a prospective portfolio, which the buyer evaluates. As with any sales transaction, the seller and buyer negotiate the price and work

out the terms of a contract. The buyer then uses its own resources, such as trained staff and technology, to collect on the account balances.

When considering whether this strategy would be beneficial, a hospital must weigh the cost of internal and/or external collections efforts with the immediate return of selling the aged accounts.⁴ Not only is it a matter of what is cost-effective, but also whether resources spent on collections would be better put to use elsewhere.

“It becomes an in-house decision of what they would like to do, and how fast they would like to get their money,” says Stuart Blatt, an attorney with Maryland-based Margolis, Pritzker, Epstein & Blatt; board member of DBA International (a debt buyers association); and past president and permanent ex-officio board member of the National Association of Retail Collection Attorneys. “It follows the adage of throwing good money after bad, or just selling it completely,” he says.

With a decision to move forward, a hospital must first determine what accounts it has available to sell. Generally, in the beginning hospitals will choose to sell their aged self-pay receivables. Hospitals that have some experience with selling their bad debt often extend the transaction by selling their “fresher” accounts receivables on a regular basis. These accounts may be as short as 60 or 90 days of discharge from the hospital. These transactions then become a regular part of the revenue-cycle management process. Insurance denials and worker’s compensation accounts are other possibilities, but generally only after the hospital has had some experience with debt selling.

Some accounts simply should not be sold. Older accounts, generally three years and older, are not good candidates for sale because they may have incorrect patient data, which can lead to public relations issues if the buyer tries to collect from the wrong person. Also, accounts with balances in the thousands of dollars should not be put up for sale. These accounts may not have been “scrubbed” enough to weed out charity care cases and billing errors.

Top 3 Tips for First-Time Sellers

Select one or two blocks of debt to start. If your experience is successful, then consider expanding the program to all debt of a certain age.

By dipping a toe into selling debt, the hospital can test the relationship with the buyer and examine the effects, if any, that the strategy will have on its business office, such as changes in patient call volume.

Optimal candidates for sale typically are “warehoused” accounts, or those that have made their way through an internal process and one or more collection agencies and are not receiving much, if any, attention. Avoid sale of receivables that may have inaccurate patient data due to age or that have not been appropriately “scrubbed” to remove accounts of those to whom collection communications would be inappropriate, such as patients who have declared bankruptcy, are deceased or incarcerated, or who are eligible for charity care. It also is in the best interest of the hospital to retain those accounts where a payment plan with the hospital or agency has been arranged or where the hospital or its agency has filed a complaint on the account in a court of law.

Understand the value of your portfolio.

A hospital should be able to get a general gauge for the value of a debt portfolio by giving a potential buyer the same basic information about the accounts that its collection agencies receive. For complete pricing, however, the hospital should research experienced, appropriately qualified buyers and then conduct a formal request for proposal process among those deemed with the best potential to meet its needs. Pricing depends on a number

of factors, including account type, age of accounts, payer mix, geographic region and demographics, average account balance, previous agency liquidation, and resale provisions. Most buyers should be able to submit a bid within a few days once given access to simple account information.

Seek terms that protect your interests.

In addition to price, criteria when evaluating bids should include the buyer’s willingness to accept contractual allowances granting the hospital necessary control. For example, hospitals may seek the ability to call back accounts at any time for any reason without a cap on quantity or the buyer’s refusal to resell accounts.

The hospital may decide to do a one-time sale of archived accounts, in which it provides the buyer with all of the charged-off and uncollected accounts going back to a certain time period and receives a lump sum in return. Or the hospital may agree to a forward-flow arrangement in which it agrees to sell accounts to the buyer on a prospective basis at an agreed price as those accounts reach an agreed age (typically monthly). Some hospitals enter agreements to sell both archived and forward-flow accounts while others choose to do only one or the other. No matter the arrangement, the purchase and sale contract should specify the collection methods allowed by the debt buyer, such as whether the buyer can place liens or send accounts to a credit-reporting bureau, and how the buyer will respond to questions from patients regarding the accounts.

The hospital also needs to consider the downsides to debt sale. For instance, the hospital may receive less for the accounts than it would have collected on its own. "When you're selling debt, obviously you get a return on your money instantly, but it usually is less than if you had sent it out to an agency or alternately to a [collections] attorney because the fees are not going to exceed anywhere from 25 percent to, let's say 40 percent," explains Blatt. "But if you're selling the paper itself, you're probably going to be selling it for pennies on the dollar."

It's important to note, however, that the benefit of selling debt generally is not in collecting a specific percentage (all or most of what's due) but simply collecting at all. For the most part, hospitals put zero to no value on the older accounts, because they put little effort on collecting them. So in such cases, cash that comes in through debt selling may be considered "found" money.

Reyes says his company typically offers a hospital the same dollars, but on an accelerated basis, that it is realizing on its aged accounts. He warns that offers from buyers that sound too good to be true, often are. Some buyers may make excessively attractive offers, but have harsh collections practices, potentially giving the hospital a public relations black eye.

"When the debt purchaser says, 'I can extract x value out of this portfolio that's incremental to yours,' I think you really have to ask the question, exactly how are you going to do that?" Reyes says. "And you need to make sure that those answers are consistent with the mission of the hospital."

Before opting to use a tiered collections strategy, Mount Carmel Health System had considered selling its aged receivables, says Karen Geisler. However, both price and uncertainty regarding the effect on its community were the main reasons why the idea was rejected. The buyers' offers simply weren't high enough, says Geisler. "And they wanted us to really go through [the accounts] and clean them up to make sure that all bankruptcies were out, all accounts where the people who have since passed away were excluded, etc."

Geisler says the amount of work the health system would have been required to do on the files at the price offered was too great. "We just didn't feel like we wanted to focus our resources on that. We thought we could do a better job [collecting on our own]," she says.

Also, because no other hospital in the Columbus market had sold its debt, Geisler says Mount Carmel didn't want to be the pioneers and possibly cause a negative perception among community members.

Geisler says the health system has not written off selling its debt entirely, however. Aged self-pay receivables have become such a dynamic issue that providers should reevaluate their collections strategy at shorter intervals, rather than waiting a decade or so, Geisler says, adding that Mount Carmel will probably reconsider the debt-selling option in a couple of years. "I'm not saying that we might never sell our bad debt, since we might," she says. "But at this point, I'm just not comfortable with it."

Gary Zmrhal, vice president and CFO at Holy Cross Hospital, Chicago, certainly is no stranger to selling debt. His first experience was back in 1999, when Zmrhal held the same position at McNeal Hospital in suburban Chicago. His most recent experience with debt selling was in May 2007 at Holy Cross, a distressed inner-city community hospital licensed for 311 beds.

Holy Cross had accumulated bad debt in excess of \$25 million over several years. Zmrhal says his reason for choosing to sell the debt is no different from why any hospital no matter its financial situation would and in fact *should* at least consider the option among other strategies: It was simply a matter of acting prudently and responsibly given the circumstances to enhance the organization's ability to serve its community.

"I believe it is a fiduciary responsibility of a CFO, as well as a finance committee and board, to have good stewardship over the assets of a hospital," he says.

Zmrhal says the potential for negative publicity that may result from selling bad debt is a factor that needs to be taken into consideration; but he also believes that consumers who

have the funds need to understand that just like a mortgage, car payment, or even grocery bill, a medical bill should be paid, too. That, in fact, is one of the benefits of selling bad debt, he says. "It does, quite frankly, send a message that, 'Hey, you as an individual are responsible for your health care. If you have the means, then you should pay,'" he says.

Selling bad debt has immediately improved cash flow, allowing Holy Cross to recover revenue for its mission of care that it otherwise wouldn't have, Zmrhal says. Because the revenue is also classified as income on the balance sheet, it helps to improve a hospital's creditworthiness to outside agencies like banks and bond holders, he says.

Zmrhal says the debt selling process really hasn't changed since his first experience nearly 10 years ago. It's still important to find a good partner and develop a contractual agreement that leans in favor of the hospital's best interests. Both the contracts he negotiated at McNeal and Holy Cross have very specific terms and conditions defining, among other things, the hospital's collection practices, which require people to be treated professionally and with dignity, Zmrhal says.

"We determined the process and, for the most part, the terms and conditions because we could always say no [and] just walk away from the deal," he says.

Zmrhal also recommends reviewing several potential buyers to get an idea of the value of the debt. The hospital should have a figure in mind, but having several candidates will offer a range of value for a hospital to consider.

Zmrhal believes that debt selling is an option that all hospitals, not just those in strained financial situations such as Holy Cross, should consider. From 1999 to 2005, Zmrhal says the hospital lost about \$65 million. Currently, it provides about \$25 million worth of charity care annually on net patient revenue of \$110 million.

He points out that hospitals in stronger financial situations also have bad debt. And, even though such hospitals may have millions in cash reserves, ignoring the option of selling their bad debt means they may be forgoing a potential opportunity to advance the care they provide to their communities. Exploring all options that might support this mission is simply being a "prudent business person," notes Zmrhal.

■ Do the Due Diligence

Hospitals that choose to sell their bad debt need to make sure they do their homework first. A buyer must be scrutinized in much the same way a collections agency is. First and foremost, the buyer must be reputable and have expertise in healthcare collection processes. The buyer must truly understand the nuances of the industry and convey a great deal of sensitivity, because unlike the credit card industry where the purchase may have been for a television set, these "consumers" are actually patients who have purchased an important and sensitive service.

Hospitals must also perform due diligence, making sure that the buyer's collection practices meet the hospital's own standards, contacting references, visiting the buyer on-site to meet the staff and assess the training program, and taking note of the security procedures in place to protect patient data, for example. The buyer's collection process should comply with the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, HIPAA, and state laws. Also, the buyer should provide documentation of its most recent audit, which should have been performed by a reputable accounting firm.



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Understanding the Sale Environment

Jon Taxdahl, managing director with CarVal Investors, discusses the trend of selling aged healthcare receivables.

Q Why has the selling of aged receivables become a viable opportunity for hospitals?

A A consistent question in the healthcare marketplace for the past three or four years has been: How do we deal with rising self-pay receivables? Generally, hospitals don't have the internal resources to collect aged self-pay accounts, so they end up with hundreds of millions, or even billions, of dollars in aged receivables. But now especially, they're looking for alternative ways to get additional capital. Hospitals are in the business of providing high-quality health care; they're not typically experts in the financial management of collections. More hospital administrators are realizing that there are organizations that are better able to manage this process without being a resource drain on the hospital. And they are finding that in return for selling their receivables, they can receive cash that goes right to the bottom line.

Q How does a hospital identify the type of receivables it may have available for sale?

A Generally, it's the aged self-pay receivables. But not every portfolio is an opportunity. It makes no sense for a hospital or buyer to participate in the sale of receivables that are too old since trying to collect old debt can cause collection challenges and make a hospital more vulnerable to negative public perception.

Another issue is the size of the balance. If the account balances are too high, concerns are: Have the adjustments been taken appropriately? Have the bills been calculated appropriately? A reputable buyer will look at accounts that are one to five years old and have balance sizes of less than \$25,000.

Q What are some of the basic things that a hospital should look for in a buyer?

A First, a hospital should look for a reputable purchaser who is able to demonstrate expertise and sensitivity in healthcare collection. Unfortunately, in the past few years, hospitals have chosen to sell to a few groups that don't have the necessary experience. We've also seen hospitals sell to brokers; this jeopardizes the hospital's reputation within the community because it can't control who the end buyer is. We encourage hospitals to look for a buyer who is socially responsible, has a patient-friendly infrastructure, understands the nuances of the market, and is credible. CarVal Investors was part of an industry group that worked with ACA International, the Association of Credit and Collection Professionals, on establishing guiding principles for healthcare collection [see www.acainternational.org]. A hospital should confirm that a buyer adheres to these principals and puts them into practice. It's similar to a seal of approval that ensures you're dealing with a good, reputable buyer.

Source: CarVal Investors

"That really is key—taking the time to understand who you're dealing with. Too often hospitals become enamored by the dollar amount [of the deal]," Reyes says. "Really, they should focus on: How is that company going to extract value? Is it consistent with the mission of our hospital? And, do they have the expertise to responsibly extract that value?"

Attorney Stuart Blatt says buyers should belong to either DBA International or ACA International, two agencies that offer guidelines on how the collections process should be handled responsibly.

The sales contract in debt buying transactions should also be constructed so that the hospital's best interests

are protected. For example, Blatt says, there should be a hold harmless agreement, which basically says that a buyer is responsible for its actions with regards to the collections process and the hospital will be held harmless of costs resulting from actions of the buyer.

The hospital should also be allowed to buy back an account. In addition, the contract should delineate the buyer's collections process so the hospital will know how the buyer will treat patients.

Also, depending on the agreement, hospitals may seek such safeguards as provisions that prevent the buyer from reselling the account, restrict having an independent agency service the account, or limit the buyer's ability to initiate legal action against the account.⁵

No matter what type of agreement is reached, hospital leadership needs to understand that the relationship with the buyer doesn't end once the transaction has been completed. Management needs to be committed to maintaining communication with the buyer to deal with issues, such as



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negative publicity, that may arise from the collections process. That's why taking the time to understand the buyer and develop a true partnership characterized by confidence and trust will make that process run a lot more smoothly.

"Know your partner, know your partner, know your partner," Reyes advises. "Perform the due diligence. Go to their site, meet the people, and talk to them. And then, finally, make sure you commit the management and technical resources necessary to direct this transaction through to a successful outcome."

Endnotes

- ¹ American Hospital Association, Uncompensated Hospital Care Cost Fact Sheet, October 2007; www.aha.org/aha/content/2007/pdf/07-uncompensated-care.pdf
- ² "Bad Debt and Reserving Methodologies in the For-Profit Hospital Sector," Lauren B. Coste and Annahita Haghgooie, Fitch Ratings, February 8, 2007; www.fitchratings.com
- ³ "Code Blue Resuscitating Bad Debt," Cliff Boyd, Healthcare Funding Solutions; www.healthcarefunding.com/images/CodeBlue.pdf
- ⁴ A hospital must also determine whether it can sell its debt. Some public companies are not allowed to do so. In this case leasing the debt may be an option.
- ⁵ Note that types and levels of restriction placed on the buyer often factor into negotiations regarding the value of the account.

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