BRYAN CAVE LEIGHTON PAISNER BCLP

Sector Focus

Authors Marc Trottier and Laura Patao-Caminas

COVID-19 and the care home sector: in the eye of the storm

KEY POINTS

- The COVID-19 pandemic may hit small care home operators hardest, but large operators are not immune.
- Formal insolvency proceedings are unlikely to significantly increase in the short term. Instead, the initial focus is likely to be on securing breathing space and implementing restructuring options.
- Where formal insolvency proceedings are required, the sector presents significant challenges for insolvency practitioners.
- COVID-19 may accelerate consolidation in the market and, hopefully, review and reform for the sector.

COVID-19: RE-OPENING OLD WOUNDS

Care homes in the UK have been battling a crisis, one that long precedes the emergence of the COVID-19 pandemic. Since 2009, funding for the adult social care sector has fallen in real terms against a backdrop of both rising demand and unrelenting cost pressures. As a result, the gap between funding needs and actual investment has progressively grown. Decades of chronic underfunding has meant that many care home operators were already teetering on a knife's edge. With COVID-19 now presenting them with new challenges, whilst simultaneously exacerbating many of their existing problems, some may now struggle to weather its effects.

The number of fatalities in care homes as a result of COVID-19, together with significantly fewer admissions and severe operational disruption, have resulted in uncertain revenues at a time when costs (particularly supplier and employment costs) have risen sharply. A significant proportion of these costs are incurred securing personal protective equipment (PPE). With the majority of available PPE supplies having been diverted to the NHS, care homes have been left in short supply. In order to protect their residents and staff, many operators have been forced to secure their own PPE, the price of which has increased by over 400%, according to the National Care Association.

Some care home operators have also suggested that, at any one time during the pandemic, anywhere between 10% and 25% of their staff have been unable to work due to sickness or the need to self-isolate, which has been compounded by the lack of available testing. In a sector required to maintain minimum staffing levels, and already dealing with significant staff shortages, some operators have struggled to fill the vacancies forcing them to rely on more expensive agency workers and overtime staff.

New challenges such as these are testing the resilience of a sector that was already suffering pre-pandemic. The resulting impact will vary between operators depending on a number of factors.

IMPACT ON CARE HOME OPERATORS

The ultimate impact of COVID-19 will perhaps be most acutely felt by single care home operators and small groups (who are likely to have less options to adapt the way in which they operate) and those that are already struggling with underlying financial and operational pressures. Large groups that have a significant number of homes, have diversified by building up a portfolio that spans a number of local authorities and that have a higher proportion of private to local authority paying residents may prove the most resilient. They should, for example, benefit from economies of scale, less exposure to local funding and demand pressures and flexibility within their portfolio to sustain underperforming care homes.

However, as Southern Cross and, more recently, Four Seasons have demonstrated, even large care home groups can be vulnerable to insolvency, particularly those that are highly geared and thinly capitalised. They may find it difficult to service their existing level of debt or, given the reduced risk appetite amongst lenders, to refinance that debt on more favourable (or even equivalent) terms. Indeed, in the midst of the current crisis, HC-One, Britain's largest care home provider, has already issued a sobering warning – the Group's directors consider '*the specific downside scenario impact of COVID-19 on the Group's occupancy levels and cash flows to be so significant that it represents a material uncertainty that may cast significant doubt on the Group's ability to continue as a going concern…*'.

Whilst nothing is certain in these unprecedented times, in the short term, we are unlikely to see a significant increase in the number of formal insolvency proceedings in relation to care homes. Lenders, investors, landlords and other creditors are likely to continue to support operators (at least initially) rather than to seek strict enforcement of their contractual rights, particularly given the nature of the crisis and the potential reputational and PR risks associated with taking any enforcement action. Meanwhile, directors will take comfort from the temporary suspension of the wrongful trading regime announced on 28 March 2020 (which has retrospective effect from 1 March 2020). This temporarily removes the threat of personal liability for those directors of companies that are genuinely struggling as a result of COVID-19 and that choose to continue to trade and incur additional liabilities where necessary. In doing so, it should reduce the number of director-led appointments of insolvency practitioners and thereby give those companies extra time in which to explore their options.

POTENTIAL OPTIONS

Given the above, we can instead expect to see measures aimed at securing breathing space, and with it the opportunity in which to

Sector Focus

Biog box

Marc Trottier is a Partner in the Restructuring & Insolvency team and Laura Patao-Caminas is an Associate Director in the M&A and Corporate Finance team at Bryan Cave Leighton Paisner. Email: marc.trottier@bclplaw.com; laura.patao-caminas@bclplaw.com

continue trading through present difficulties and possibly implement restructuring options. This is likely to include one or a combination of the following:

- renegotiation of existing covenants contained in finance documents and operating leases (particularly occupancy, lease coverage ratios and other financial covenants);
- entry into standstill, forbearance or other similar agreements;
- investors (particularly private equity houses) revisiting and resetting both their timetable to exit and any management incentive plans;
- fundraising (be this the extension of credit lines with existing providers of finance or the raising of funds from existing or new investors);
- an increase in company voluntary arrangements (CVAs), particularly given the practical challenges associated with formal insolvency proceedings in the care home sector;
- solvent restructuring of corporate group structures to reduce administration costs; and
- refinancing, consolidating or otherwise restructuring existing debt (including by way of debt for equity swap).

For operators that own their own sites, post the COVID-19 pandemic we may see a resurgence of sale and leaseback transactions in order to bolster the operator's balance sheet.

Where a care home operator's creditors are not supportive, or the above options are not available or do not produce the necessary improvements in its financial position, COVID-19 may prove to be the last straw, giving rise to formal insolvency proceedings.

COMPLEXITY OF CARE HOME INSOLVENCIES

The institution of formal insolvency proceedings is an unattractive prospect for any company in financial difficulty. However, for care home operators, it is also more complicated than might be the case for companies operating in almost any other sector.

The complex legal and regulatory landscape in which care homes operate make trading a care home business in administration a very challenging proposition for insolvency practitioners. In some cases, they may not have the expertise and resources to do so. In other cases, they simply may not have the appetite to accept the potential risks that are associated with running a care home business. Where this is the case, a third party, normally another care home operator, can be appointed to run the business on its behalf. Whilst this addresses the problem, it creates significant additional delay and expense and may not lead to the best possible outcome for creditors as a whole.

A pre-pack sale avoids the need for an insolvency practitioner to trade the business in insolvency, but is not always a particularly practical solution where care homes are concerned. One of the key advantages of a pre-pack (a quick transfer of a business to a new owner) is negated by the fact that care home registrations, which are required to be secured and maintained by care home operators, cannot be transferred. In a pre-pack sale, this can have significant timing implications as the transaction is likely to be structured such that completion cannot occur unless or until the buyer has satisfied the requisite registration requirements.

THE LONG TERM

The current pandemic has served to reaffirm the characteristics that have seen private investment into the sector increase over the last decade – the provision of essential services, defensive characteristics and stable, low-risk returns over the long-term. The underlying investment case for the social care sector has not therefore materially changed. Many investors, having first turned inwards to manage their existing portfolios, still have significant capital to deploy and are beginning to express a renewed desire to enter the adult social care sector or to expand their existing portfolios. For some operators, a solvent sale of all or part of their portfolio may therefore present as an attractive solution. For others, formal insolvency proceedings may be unavoidable and, if the company cannot be rescued so that it can continue trading as a going concern, sales out of insolvency will necessarily follow. The COVID-19 pandemic will likely therefore accelerate the existing trend for consolidation in the current fragmented market.

For care home operators, if there is a silver lining amongst the current human and economic crisis, it is perhaps that the COVID-19 pandemic has served to shine a light on the critical role that the social care sector plays in the fabric of our society and its inexorable link with the NHS. Providers of social care have long felt overshadowed by the NHS, despite assurances from the government to the contrary. However, with the government's green paper on the reform and funding of social care still not having seen the light of day, and with the majority of public funds for health and social care continuing to be directed to the NHS, the government has arguably done little to demonstrate otherwise. This newly found appreciation for the sector must, once the crisis is over, translate into review and reform and concrete funding solutions. The challenge for all participants in the sector will be to ensure that, in the wake of the crisis, this is not forgotten.

Further reading

- National Care Association, 12 May 2020, 'COVID-19 Statement From The Board Of National Care Association'. Available at: https://nationalcareassociation.org.uk/news-events/news/covid-19-statement-from-the-board-of-national-care-association/p2
- Annual report and financial statements of HC-One Limited for the year ended 30 September 2019, note 1 (Accounting policies, Going concern and COVID-19), p 14.
- Practice Note: Guide to insolvency in the care home industry – LexisPSL Restructuring & Insolvency; Insolvency trading issues; Sale and purchase of assets