AMERICAN BANKRUPTCY INSTITUTE

2021 Virtual Annual Spring Meeting

# Cutting-Edge Commercial Law/ Regulatory Issues in Health Care Insolvencies

*Hosted by the Commercial and Regulatory Law and Health Care Committees*


**Tania M. Moyron**
*Dentons; Los Angeles*

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*KEWA Financial Inc.; Lexington, Ky.*


CONCURRENT SESSION

2021

AMERICAN BANKRUPTCY INSTITUTE 2021 ANNUAL SPRING MEETING

# CUTTING EDGE COMMERCIAL LAW / REGULATORY ISSUES IN HEALTH CARE INSOLVENCIES

***Presented by the Commercial & Regulatory Law and Health Care Committees***

**April 13, 2021**

**Daniel I. Waxman, Moderator**
*KEWA Financial Inc. / Lexington, Kentucky*

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AMERICAN BANKRUPTCY INSTITUTE 2021 ANNUAL SPRING MEETING

# GENERAL TOPICS AND ASSOCIATED MATERIALS

## Setoff, Recoupment, and Related Issues

- *In re Gardens Regional Hospital and Medical Center, Inc.*, 975 F.3d 926 (9th Cir. 2020)
- *In re Orexigen Therapeutics, Inc.*, 990 F.3d 748 (3d Cir. 2021)
- *In re THG Holdings LLC*, 604 B.R. 154 (Bankr. D. Del. 2019)

## Maintenance and Disposal of Records (Electronic and Physical)

- *In re Kentuckiana Medical Center, LLC*, Case No. 19-90617 (Bankr. S.D. Ind.)
    - Trustee's Motion for Authority to Enter into an Agreement for the Storage and Disposal of Patient Medical Records [Docket No. 139]
    - Trustee's Motion for Authority to Enter into an Agreement for Access to Certain Electronic Patient and Financial Records [Docket No. 146]
- *In re ITT Educational Services, Inc.*, Case No. 16-07207 (Bankr. S.D. Ind.)
    - Trustee's Brief in Support of Trustee's Motion to Establish Certain Protocols and Procedures for Requesting Documents [Docket No. 1924]
    - Westchester Fire Insurance Company's Brief in Opposition to Trustee's Motion to Establish Certain Protocols and Procedures for Requesting Documents [Docket No. 1802]

## Concerns Specific to Non-Profit Debtors

- Outline of bankruptcy issues related to non-profit debtors
- *In re Verity Health System of California, Inc.*, 2019 WL 5585007 (Bankr. C.D. Cal. Oct. 23, 2019) (vacated)

AMERICAN BANKRUPTCY INSTITUTE 2021 ANNUAL SPRING MEETING

# SETOFF, RECOUPMENT & RELATED ISSUES

975 F.3d 926
United States Court of Appeals, Ninth Circuit.

# IN RE GARDENS REGIONAL HOSPITAL AND MEDICAL CENTER, INC., Debtor, Gardens Regional Hospital and Medical Center Liquidating Trust, Appellant,

v.

State of California, and its Department of Health Care Services, Appellees.

No. 18-60016
|
Argued and Submitted October 16, 2019 Pasadena, California
|
Filed September 16, 2020

**Synopsis**

**Background:** Debtor-hospital, a Medicaid provider, objected to State's allegedly willful violation of automatic stay in withholding postpetition payments to which it was entitled and moved to compel turnover of the withheld funds. The United States Bankruptcy Court for the Central District of California, Ernest M. Robles, J., 569 B.R. 788, denied the motion, and debtor appealed. The United States Bankruptcy Appellate Panel for the Ninth Circuit, No. 17-1198, 2018 WL 1354334, affirmed. Debtor appealed.

**Holdings:** The Court of Appeals, Collins, Circuit Judge, held that:

[1] debtor-hospital's obligation to the State for quarterly Hospital Quality Assurance (HQA) fees could be used, on recoupment theory, to reduce the State's obligation to debtor for supplemental HQA payments, but

[2] debtor-hospital's obligation to the State for quarterly Hospital Quality Assurance (HQA) fees could not be used by the State to reduce its fee-for-service obligation to debtor unless the State satisfied requirements for setoff.

Affirmed in part, reversed in part, and remanded.

West Headnotes (19)

[1] **Bankruptcy** ⇨ Set-offs and counterclaims; cross claims

**Bankruptcy** ⇨ Set-off or recoupment in general

Bankruptcy Code limitations on a creditor's ability to effect a postpetition "setoff" did not apply to the extent that the creditor's actions were covered by the related, but distinct doctrine of equitable recoupment. 11 U.S.C.A. §§ 362(a)(7), 553.

[2] **Set-off and Counterclaim** ⇨ Equitable Set-off

Right of setoff allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding absurdity of making A pay B when B owes A.

[3] **Set-off and Counterclaim** ⇨ Equitable Set-off

Defining characteristic of "setoff," as opposed to recoupment, is that, in a setoff, the mutual debt and claim are generally those arising from different transactions.

[4] **Bankruptcy** ⇨ Set-off or recoupment in general

Bankruptcy Code does not itself create setoff rights, but instead imposes certain federal law limitations on their recognition in bankruptcy. 11 U.S.C.A. §§ 362(a)(7), 553.

[5] **Bankruptcy** ⇨ Prepetition, post-petition, and unmatured debts

Under setoff provision of the Bankruptcy Code, each debt or claim sought to be offset must have arisen prior to filing of bankruptcy petition. 11 U.S.C.A. § 553(a).

[6] **Bankruptcy** ⇨ Mutuality; identity of right, person, and capacity

Setoff provision of the Bankruptcy Code limits setoff in bankruptcy to the setting off of mutual debts owed by a creditor to debtor against creditor's claim against the debtor, and this "mutuality" requirement is strictly construed. 11 U.S.C.A. § 553(a).

[7] **Set-off and Counterclaim** ⇨ Recoupment or reconvention

Conceptual foundation of equitable recoupment is not the adjustment of separate mutual debts but the process of defining the amount owed on a single claim.

[8] **Bankruptcy** ⇨ Set-off or recoupment in general

Recoupment is not subject to all of the same strictures in bankruptcy as is exercise of right of setoff. 11 U.S.C.A. § 553(a).

[9] **Bankruptcy** ⇨ Prepetition, post-petition, and unmatured debts

Unlike exercise of right of setoff in bankruptcy, recoupment is not limited only to prepetition claims and thus may be employed to recover across the petition date. 11 U.S.C.A. § 553(a).

[10] **Bankruptcy** ⇨ Mutuality; identity of right, person, and capacity

In order for creditor to exercise alleged right of recoupment in bankruptcy, the claims or rights giving rise to recoupment must arise from the same transaction or occurrence that gave rise to the liability sought to be enforced by the bankruptcy estate.

[11] **Bankruptcy** ⇨ Mutuality; identity of right, person, and capacity

Recoupment in bankruptcy context is the setting up of a demand arising from the same transaction as creditor's claim or cause of action, strictly for the purpose of abatement or reduction of that claim.

[12] **Bankruptcy** ⇨ Mutuality; identity of right, person, and capacity

Crucial factor for court in deciding whether the claims or rights giving rise to alleged right of recoupment arise from same transaction or occurrence that gave rise to the liability sought to be enforced by the bankruptcy estate, as required by recoupment doctrine, is the logical relationship between the two.

[13] **Bankruptcy** ⇨ Mutuality; identity of right, person, and capacity

While flexible, the 'logical relationship' test for whether claims and debts arise from the same transaction, as required for exercise of right of recoupment in bankruptcy, is not to be applied so loosely that multiple occurrences in any continuous commercial relationship would constitute one transaction; the test remains whether the relevant rights being asserted against the debtor are sufficiently logically connected to debtor's countervailing obligations, such that they may be fairly said to constitute part of same transaction.

[14] **Bankruptcy** ⇨ Set-off or recoupment in general

Courts should apply the recoupment doctrine in bankruptcy cases only when it would be inequitable for debtor to enjoy the benefits of transaction without meeting its obligations.

1 Cases that cite this headnote

[15] **Bankruptcy** ⇨ Set-off or recoupment in general

Care should be taken in applying the doctrine of recoupment in bankruptcy context.

1 Cases that cite this headnote

[16] **Bankruptcy** ⇨ Scope of review in general

Court of Appeals reviews decisions of the Bankruptcy Appellate Panel (BAP) de novo, applying the same standard of review to bankruptcy court's decision that the BAP applied.

1 Cases that cite this headnote

[17] **Bankruptcy** ⇨ Conclusions of law; de novo review

**Bankruptcy** ⇨ Clear error

On subsequent appeal, the Court of Appeals reviews the bankruptcy court's legal conclusions de novo and its factual findings for clear error. Fed. R. Bankr. P. 8013.

[18] **Bankruptcy** ⇨ Governmental claims; immunity waiver

Debtor-hospital's obligation to the State for quarterly Hospital Quality Assurance (HQA) fees which it was required to pay, and which the State then used, along with federal matching funds, to make supplemental HQA payments to debtor and other hospitals, arose out of "same transaction or occurrence" as the State's obligation to debtor for these supplemental HQA payments, such that the State could exercise right of recoupment in bankruptcy by withholding supplemental HQA payments; while different formulas were used to calculate debtor's quarterly HQA fees and supplemental HQA payments to which it was entitled, this did not affect logical relationship that existed between these obligations.

[19] **Bankruptcy** ⇨ Governmental claims; immunity waiver

Debtor-hospital's obligation to the State for quarterly Hospital Quality Assurance (HQA) fees which it was required to pay, and which the State then used, along with federal matching funds, to make supplemental HQA payments to debtor and other hospitals, did not arise out of "same transaction or occurrence" as the State's obligation to debtor for Medi-Cal payments that debtor was entitled to receive for providing medical services to Medicaid patients, and could not be used by the State to reduce its obligation to debtor-hospital for these Medi-Cal payments unless the State satisfied requirements for exercise of right of setoff; statutory bases that existed for the obligations and for the State's right to make deductions, and fact that both obligations were ultimately rooted in debtor-hospital's provider agreement with the State, was insufficient to supply requisite logical relationship. 11 U.S.C.A. § 553(a).

**Attorneys and Law Firms**

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Kenneth K. Wang (argued), Deputy Attorney General; Jennifer M. Kim, Supervising Deputy Attorney General; Julie Weng-Gutierrez, Senior Assistant Attorney General; Xavier Becerra, Attorney General; Office of the Attorney General, Los Angeles, California; for Appellee.

Appeal from the Ninth Circuit Bankruptcy Appellate Panel Lafferty, Kurtz, and Faris, Bankruptcy Judges, Presiding, BAP No. 17-1198

Before: Kim McLane Wardlaw and Daniel P. Collins, Circuit Judges, and Joseph F. Bataillon,* District Judge.

**OPINION**

COLLINS, Circuit Judge:

This case requires us to address the extent to which a creditor can deduct the amounts that a bankrupt debtor owes to that creditor from other payments that the creditor owes to the debtor. The Bankruptcy Code imposes significant limitations on such deductions if they constitute a "setoff," but the courts have consistently recognized an exception to those limitations in the case of deductions that fall within the equitable

doctrine of "recoupment." Here, after Gardens Regional Hospital and Medical Center, Inc. ("Gardens Regional") filed for bankruptcy, the State of California and its Department of Health Care Services (collectively, "California" or "the State") deducted certain "fees"—which Gardens Regional had failed to pay to the State—from various payments that the State was obligated to make to Gardens Regional under its Medicaid program. Gardens Regional contended that the deductions were impermissible setoffs, and California argued that there were instead permissible recoupments. The bankruptcy court and the Ninth Circuit Bankruptcy Appellate Panel ("BAP") both agreed with California, but we conclude that they relied on an overbroad conception of "recoupment." Because some of the deductions claimed by California constituted setoffs, and not recoupments, we affirm in part and reverse in part and remand for further proceedings.

## I

An understanding of this case requires a brief summary of both the structure of California's Medicaid program and the underlying background facts concerning the parties' dispute.

### A

Under the Medicaid program, the federal government provides financial support to qualifying state plans that provide "medical assistance" and other services to defined classes of individuals "whose income and resources are insufficient to ***930** meet the costs of necessary medical services." 42 U.S.C. § 1396-1. California's approved Medicaid program, known as "Medi-Cal," is managed by Defendant Department of Health Care Services (the "Department") and provides benefits to covered individuals through two primary methods—a "fee-for-service" system and a "managed care" system. *See Marquez v. Dep't of Health Care Servs.*, 240 Cal.App.4th 87, 192 Cal. Rptr. 3d 391, 397–98 (2015); Cal. Welf. & Inst. Code §§ 14016.5(a)–(b), 14062, 14100.1. Under the "fee-for-service" system—which is the relevant payment method for purposes of this case—a covered individual may receive treatment at a participating healthcare provider, and Medi-Cal then directly pays that provider a specified amount for each covered service provided to the individual. *See Marquez*, 192 Cal. Rptr. 3d at 397. The amount paid for each service is determined "in one of two ways: (1) according to a specific contractual rate of payment negotiated between the hospital and an arm of the Department ...; or (2) for California hospitals that have not negotiated contracts ..., on the basis of costs, in accordance with various regulatory formulas." *Mission Hosp. Reg'l Med. Ctr. v. Shewry*, 168 Cal.App.4th 460, 85 Cal. Rptr. 3d 639, 647 (2008).[1] Gardens Regional has not negotiated its own schedule of contractual rates and is therefore considered a "noncontract" hospital.[2]

Given that Medicaid is a federal-state cost-sharing program, it is not surprising that federal law places limits on how States can raise their share of Medicaid funding. Prior to amendments enacted in 1991, some States engaged in a circular-funding practice in which they "would make payments to hospitals, collect the federal matching funds, and then recover a portion of the payments made to hospitals through the collection of a health care related tax imposed on the hospitals." *Abraham Lincoln Mem'l Hosp. v. Sebelius*, 698 F.3d 536, 544 (7th Cir. 2012). Under such schemes, the States' lower *net* payments to hospitals were effectively inflated for purposes of calculating federal matching funds. Congress eliminated this practice by providing that "the amount of federal matching funds provided to a State should be reduced by the amount of any revenues received by the State through a health care related tax *that was not broad-based* [or] that contained a *hold harmless* provision." *Id.* (emphasis added) (citing 42 U.S.C. § 1396b(w)(1)(A)(ii)–(iii)). In order to qualify as a "broad-based health care related tax," a state exaction generally must be imposed uniformly on "all non-Federal, nonpublic providers in the State," and not just on Medicaid providers. *See* 42 U.S.C. § 1396b(w)(3)(B). A broad-based tax will be considered as having an impermissible "hold harmless" provision if, *inter alia*, the Medicaid payments to a provider "var[y] based only upon the amount of the total tax paid"; the provider receives a waiver or offset of a portion of the tax; or the provider receives payments that "positively correlate[ ]" to the amount of the tax. *Id.* § 1396b(w)(4)(A)–(C).

***931** Invoking this federal-law exception for certain broad-based healthcare taxes, California in 2009 passed legislation that would lead to the imposition of a "Hospital Quality Assurance Fee" ("HQAF") on non-public hospitals in the State. *See* Quality Assurance Fee Act, 2009 Cal. Stat. ch. 627, § 2. In its current form, the HQAF is imposed on most non-public, "general acute care hospital[s]" without regard to whether they participate in Medi-Cal. *See* Cal. Welf. & Inst. Code § 14169.52(a); *see also id.* § 14169.51(*l*) (exempting, *inter alia*, certain public hospitals, long-term care hospitals, and "small and rural" hospitals). If a hospital does

not pay its HQAF assessments, the statute allows the State to "immediately begin to deduct the unpaid assessment and interest from any Medi-Cal payments owed to the hospital, or ... from any other state payments owed to the hospital." *Id.* § 14169.52(h).

The legislatively declared purpose of the HQAF is "to increase federal financial participation in order to make supplemental Medi-Cal payments to hospitals, and to help pay for health care coverage for low-income children." *Id.* § 14169.50(d). Towards that end, the statute requires that HQAF proceeds be deposited into "segregated funds" that are to be used only for certain enumerated purposes. *Id.* § 14169.50(f)(2). Those purposes are: (1) supplemental payments to private hospitals based upon their overall provision of outpatient and inpatient services, *id.* §§ 14169.54, 14169.55; (2) increased payments for Medi-Cal managed health care plans, *id.* § 14169.56; (3) direct grants to public hospitals, *id.* § 14169.58; (4) funding for health coverage for low-income children, *id.* § 14169.53(b); and (5) administrative costs, *id.* Any supplemental payments made to private hospitals under the HQAF program are "in addition to any other amounts payable to hospitals with respect to those services." *Id.* § 14169.54(a); *id.* § 14169.55(a) (same).

**B**

Gardens Regional was a private nonprofit hospital in Hawaiian Gardens, California, and since at least November 2014 it was a participating Medi-Cal provider. After Gardens Regional began experiencing significant financial difficulties, it stopped paying its HQAF assessments in March 2015, and it ultimately filed for Chapter 11 bankruptcy in June 2016. It ceased operations in February 2017.

According to the State, Gardens Regional owed California $699,173 in missed HQAF payments at the time it filed for bankruptcy. Thereafter, the State fully recovered this prepetition debt by withholding a portion of its Medi-Cal payments to the hospital, which included both fee-for-service payments and "supplemental" payments under the HQAF program. As additional HQAF assessments accrued postpetition and were likewise not paid by Gardens Regional, the State continued to deduct a portion of the fee-for-service and supplemental payments to the hospital. All told, the State withheld a total of $4,306,426 from Gardens Regional, and it claims that Gardens Regional still owes $2,550,667 in HQAF debt.

In May 2017, as debtor in possession, Gardens Regional filed a motion with the bankruptcy court attempting to compel the State to return the amounts it had withheld, so that those funds would then be available for the benefit of the bankruptcy estate and the hospital's other creditors.[3] ***932** Gardens Regional argued that, in withholding the funds, California had violated the Bankruptcy Code's "automatic stay," which generally prohibits creditors from attempting to collect on their claims against the debtor after the filing of a bankruptcy petition. 11 U.S.C. § 362(a). The automatic stay specifically prohibits, *inter alia*, the "setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor," *id.* § 362(a)(7), and Gardens Regional argued that California's withholding of a portion of the payments due to the hospital constituted such an impermissible setoff. The State disagreed, contending that its actions were exempt from the automatic stay under the non-statutory equitable doctrine of "recoupment."

The bankruptcy court denied Gardens Regional's motion, holding that California had the right to recoup the funds because there was enough of a "logical relationship" between both the fee-for-service payments and the supplemental payments, on the one hand, and the HQAF assessments, on the other. *In re Gardens Reg'l Hosp. & Med. Ctr., Inc.*, 569 B.R. 788, 794–99 (Bankr. C.D. Cal. 2017). Gardens Regional appealed to the BAP, which affirmed the bankruptcy court. *In re Gardens Reg'l Hosp. & Med. Ctr., Inc.*, 2018 WL 1354334, at *4–6 (B.A.P. 9th Cir. March 12, 2018). Gardens Regional appealed to this court, and we have jurisdiction under 28 U.S.C. § 158(d).[4]

**II**

**[1]** In the proceedings below, Gardens Regional argued that the State's withholding of unpaid HQAF amounts constituted an improper "setoff" that violated the automatic stay imposed under § 362 of the Bankruptcy Code. However, we have held —and Gardens Regional acknowledges—that to the extent a creditor's actions were covered by the related but distinct doctrine of equitable "recoupment," the Code's limitations on "setoffs" would *not* apply. *See Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1403 (9th Cir. 1996) (referring to recoupment " 'as a non-statutory, equitable exception to the automatic stay' " (citation omitted)); *see also id.* at 1399 (" '[T]he chief importance of the recoupment doctrine in bankruptcy is that, unlike setoff, recoupment is often

thought not to be subject to the automatic stay.' " (citation omitted)). Thus, while "[r]ecoupment and setoff have much in common," the differences between these two doctrines have "important consequences in the bankruptcy context." *Sims v. U.S. Dep't of Health & Human Servs.* (*In re TLC Hosps., Inc.*), 224 F.3d 1008, 1011 (9th Cir. 2000). Here, the bankruptcy court and the BAP held that *all* of the State's withholdings of unpaid HQAF amounts constituted legitimate instances of equitable recoupment rather than setoff, but in our view this holding rested on an overly generous conception of what qualifies as "the *same transaction or occurrence*" for purposes of recoupment. *See id.*

A

The doctrines of setoff and recoupment trace their origins back to "the era of common law pleading," when they allowed ***933** a defendant to assert certain countervailing claims that might not otherwise have been allowed under the then-stricter joinder rules. *Lee v. Schweiker*, 739 F.2d 870, 875 (3d Cir. 1984). As developed in that pleading context, "[s]etoff allowed a reduction of [the] plaintiff's claim by the amount of a liquidated claim of the plaintiff to the defendant; recoupment allowed a defendant to assert a claim arising out of the same transaction as the plaintiff's claim." *Id.* at 875 n.5. Both doctrines were subsequently recognized in bankruptcy, "setoff by statute and recoupment by decision." *Id.* at 875 (citation and footnote omitted). Although their function as pleading doctrines has not entirely disappeared in the bankruptcy context, *see Reiter v. Cooper*, 507 U.S. 258, 265 n.2, 113 S.Ct. 1213, 122 L.Ed.2d 604 (1993), the two concepts now play a role in bankruptcy that is "very different from their original role as rules of pleading," *Lee*, 739 F.2d at 875.

**[2]** **[3]** **[4]** **[5]** **[6]** As the Supreme Court has explained, the right of setoff "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.' " *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18, 116 S.Ct. 286, 133 L.Ed.2d 258 (1995) (quoting *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528, 33 S.Ct. 806, 57 L.Ed. 1313 (1913)). "The defining characteristic of setoff"—as opposed to recoupment—is that, in a setoff, " 'the mutual debt and claim ... are generally those arising from *different* transactions.' " *Newbery*, 95 F.3d at 1398 (citation omitted). Although the Bankruptcy Code does not itself create setoff rights, it imposes certain federal-law limitations on their recognition in bankruptcy. For example, we have stated that, under § 553(a) of the Code, "each debt or claim sought to be offset must have arisen prior to [the] filing of the bankruptcy petition." *Id.* Section 553(a) also limits setoff in bankruptcy to the setting off of " 'a *mutual* debt' owed by a creditor to the debtor against the creditor's claim against the debtor," and this "mutuality requirement" is "strictly construed." *Id.* at 1399 (emphasis added) (citation omitted). And, as noted earlier, a creditor's right to assert a "setoff" is expressly limited by the Code's automatic-stay provision. *See* 11 U.S.C. § 362(a)(7).

**[7]** **[8]** **[9]** By contrast, the conceptual foundation of equitable recoupment is not the adjustment of separate mutual debts but the process of defining the amount owed under a single claim. *See Reiter*, 507 U.S. at 265 n.2, 113 S.Ct. 1213 ("Recoupment permits a determination of the 'just and proper liability on the main issue[.]' ") (citation omitted); *Chicago Title Ins. Co. v. Seko Inv., Inc.* (*In re Seko Inv., Inc.*), 156 F.3d 1005, 1008–09 (9th Cir. 1998) ("If recoupment applies, the creditor's claim arises from the same transaction as the debtor's claim, and it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation." (simplified)). Because "recoupment is in the nature of *a right to reduce the amount of a claim*, and does not involve establishing the existence of *independent* obligations," 5 Collier on Bankruptcy ¶ 553.10 (Richard Levin & Henry J. Sommer, eds., 16th ed. 2019) (emphasis added), the caselaw has recognized that recoupment is not subject to all of the same strictures in bankruptcy as setoff. For example, because "the limits placed on setoff under section 553 generally do not apply to recoupment claims," *Newbery*, 95 F.3d at 1399, "[u]nlike setoff, recoupment is not limited to pre-petition claims and thus may be employed to recover across the petition date," *Sims*, 224 F.3d at 1011. And as noted earlier, " 'unlike setoff, recoupment is often thought not to be subject to the ***934** automatic stay.' " *Newbery*, 95 F.3d at 1399 (citation omitted).

**[10]** **[11]** **[12]** We have emphasized that the "limitation of recoupment that balances [these] advantage[s]" under bankruptcy law "is that the claims or rights giving rise to recoupment must arise from the *same transaction or occurrence* that gave rise to the liability sought to be enforced by the bankruptcy estate." *Sims*, 224 F.3d at 1011. Accordingly, we have defined recoupment in the bankruptcy context as " 'the setting up of a demand arising from the *same transaction* as the plaintiff's claim or cause of action, *strictly* for the purpose of abatement or reduction of such claim.' " *Newbery*, 95 F.3d at 1399 (second emphasis added)

(citation omitted). In addressing whether the countervailing claims or rights asserted by the creditor arise from the same transaction or occurrence—and therefore qualify as a permissible recoupment for federal bankruptcy purposes —we "have held that the crucial factor ... is the 'logical relationship' between the two." *Sims*, 224 F.3d at 1012 (quoting *Newbery*, 95 F.3d at 1403).

In *Newbery*, we derived this "logical relationship" test from the Supreme Court's analysis of pleading standards governing compulsory counterclaims in the era prior to the Federal Rules of Civil Procedure. 95 F.3d at 1402 (citing *Moore v. N.Y. Cotton Exch.*, 270 U.S. 593, 610, 46 S.Ct. 367, 70 L.Ed. 750 (1926)). That makes sense, given the common-law-pleading origins of the doctrine, *Lee*, 739 F.2d at 875, and indeed, recoupment has been described as "the ancestor of the compulsory counterclaim and setoff of the permissive counterclaim," *Coplay Cement Co. v. Willis & Paul Grp.*, 983 F.2d 1435, 1440 (7th Cir. 1993) (citations omitted); *see generally* 6 Charles Alan Wright, Arthur R. Miller, & Mary K. Kane, Federal Practice & Procedure § 1401 (3d ed. 2010). In both *Newbery* and *Sims*, we noted that the Supreme Court in *Moore* had held that whether claims or rights arise from the same transaction " 'depend[s] not so much upon the immediateness of their connection as upon their logical relationship.' " *Sims*, 224 F.3d at 1012 (quoting *Moore*, 270 U.S. at 610, 46 S.Ct. 367); *see also Newbery*, 95 F.3d at 1402 (same). In *Sims*, we therefore expressly rejected "the Third Circuit's narrow definition of 'transaction,' " which in our view improperly gave dispositive weight to the temporal immediacy of the countervailing claims rather than to their logical relationship. 224 F.3d at 1014 (citing *University Med. Ctr. v. Sullivan* (*In re Univ. Med. Ctr.*), 973 F.2d 1065, 1081 (3d Cir. 1992)).

**[13]** **[14]** **[15]** While we have thus noted the "flexible meaning" of the same-transaction requirement, *see Newbery*, 95 F.3d at 1402, we have also cautioned that "the 'logical relationship' concept is not to be applied so loosely that multiple occurrences in any continuous commercial relationship would constitute one transaction," *Sims*, 224 F.3d at 1012. The test remains whether the relevant rights being asserted against the debtor are sufficiently logically connected to the debtor's countervailing obligations such that they may be fairly said to constitute part of the same transaction. *Sims*, 224 F.3d at 1012; *Newbery*, 95 F.3d at 1401–02. Moreover, while we have rejected the Third Circuit's narrow focus on temporal proximity, we have stated our express agreement with that court's separate "observation that courts should apply the recoupment doctrine in bankruptcy cases only when 'it would ... be inequitable for the debtor to enjoy the benefits of that transaction without meeting its obligations.' " *Newbery*, 95 F.3d at 1403 (alteration in original) (quoting *University Med. Ctr.*, 973 F.2d at 1081); *see also Sims*, 224 F.3d at 1014. Furthermore, as Collier explains, ***935** "care should be taken" in applying the doctrine of recoupment in the bankruptcy context, given that "improper application of the doctrine, coupled with its ostensibly exempt status under sections 553(a) and 362, could undermine the fundamental purposes of these statutory provisions." 5 Collier on Bankruptcy, *supra*, ¶ 553.10[3]. "[A]pplication of the doctrine in any particular case" is therefore "sometimes scrutinized from the perspective of its effect on the fundamental policies of these provisions." *Id.*; *see also Malinowski v. N.Y. State Dep't of Labor* (*In re Malinowski*), 156 F.3d 131, 134 (2d Cir. 1998) (recoupment should not be broadened "in contravention of the federal bankruptcy policies of debtor protection and equal distribution to creditors").

**B**

The proper application of these principles is illustrated by our decisions in *Newbery* and *Sims*.

The facts of *Newbery* are somewhat complex, but they are important to a proper understanding of that decision. Newbery, an electrical subcontractor, obtained from its surety, Fireman's Fund, "performance and payment bonds" that "guaranteed that Newbery's work would be completed and its employees and suppliers paid." 95 F.3d at 1396. In procuring the bonds, Newbery in turn agreed to indemnify Fireman's Fund against any losses stemming from the bonds. *Id.* Newbery subsequently abandoned its projects and "defaulted on the bonds," leaving unpaid its indemnification obligation to Fireman's Fund. *Id.* As part of an agreement between Newbery, Fireman's Fund, and Citibank (which held a security interest in Newbery's equipment), Newbery agreed to transfer the relevant projects to Fireman's Fund, which hired a subcontractor to complete them. *Id.* As part of that agreement, Citibank agreed to rent out Newbery's equipment to Fireman's Fund. *Id.* at 1396–97. Shortly after the agreement was signed, Newbery filed for bankruptcy. *Id.* at 1397. During bankruptcy proceedings, Newbery asserted a separate, multi-million-dollar claim against Citibank, and Newbery and Citibank ultimately entered into a settlement in which, *inter alia*, Citibank transferred to Newbery its right to

receive rental payments from Fireman's Fund. *Id.* The result of this complex series of interrelated agreements was that Newbery was entitled to receive equipment rental payments from Fireman's Fund for Fireman's Fund's use of Newbery's former equipment to complete Newbery's former projects. *Id.* After Fireman's Fund failed to pay the rent on the equipment, Newbery brought suit. *Id.* Fireman's Fund asserted alternative defenses of recoupment and setoff, noting that Newbery was liable to Fireman's Fund for indemnification of its losses, which Fireman's Fund suffered due to Newbery's failure to complete the projects in the first place. *Id.* at 1397 & n.4.

Applying the "logical relationship" test, we concluded that Fireman's Fund was entitled to recoupment. 95 F.3d at 1401–04. In reaching this conclusion, we relied on two key features of the resulting relationship between the rental payments due to Newbery and the claims for indemnification asserted by Fireman's Fund. *Id.* at 1402–03. First, we found it significant that the agreement between Newbery, Fireman's Fund, and Citibank that created the rental-payment obligation also incorporated by reference Newbery's original indemnification agreement with Fireman's Fund. 95 F.3d at 1402. As a result, under the applicable Arizona contract law, the two countervailing claims each arose from the same contract. *Id.* Second, we emphasized that the two obligations at issue in ***936** *Newbery* arose "from the very same acts." 95 F.3d at 1403. That conclusion made perfect sense, because Fireman's Fund was renting Newbery's equipment to complete *the very same projects for which Fireman's Fund had bonded Newbery*. We held that this factual "intertwining of opposing claims" distinguished *Newbery* from the Third Circuit's decision in *University Medical Center*, which had rejected the view that a common grounding in the same underlying contract was *alone* sufficient to support recoupment. *Id.* (citing *University Med. Ctr.*, 973 F.2d at 1081). We also rejected the Third Circuit's overly restrictive recoupment test, which further required that both debts " 'arise out of a single *integrated* transaction,' " and held that the requisite factual connection was present in *Newbery*. *Id.* (quoting *University Med. Ctr.*, 973 F.2d at 1081) (emphasis added). Based on these legal and factual connections between the two countervailing obligations in *Newbery*, we found the necessary "logical relationship" to justify recoupment. *Id.* at 1403.

In *Sims*, we likewise emphasized both the legal and factual connections between the two claims in applying the logical-relationship test. 224 F.3d at 1012–14. There, we addressed Medicare's system of making payments to providers "on an *estimated* basis prior to an audit which determines the precise amount of reimbursement due to the provider." *Id.* at 1011. At the end of each reporting year, a "fiscal intermediary under contract" with the Government would "conduct[ ] an audit of the provider" and determine whether the amount due for the provider's *actual* services were lower than the estimate, resulting in an overpayment. *Id.* at 1012. One option for recovering overpayments was to "adjust subsequent reimbursement payments," meaning that "overpayments from one fiscal year may be recovered by adjusting the interim payments for a subsequent fiscal year." *Id.* After TLC Hospitals, Inc. filed for bankruptcy, it argued, *inter alia*, that the Government could not recapture prepetition overpayments from postpetition reimbursements, because that would constitute an impermissible setoff "across the petition date." *Id.* at 1010. The Government, in turn, asserted that such recapture would constitute a permissible equitable recoupment. *Id.*

We agreed with the Government, holding that "under this specialized and continuous system of estimated payments and subsequent adjustments, [the Government's] overpayments and its underpayments in a subsequent fiscal year were parts of the same transaction for purposes of recoupment." 224 F.3d at 1012. In light of the "continuous balancing process between the parties," we "conclude[d] that the distinctive Medicare system of *estimated payments and later adjustments* does qualify as a single transaction for purposes of recoupment." *Id.* (emphasis added). We further explained that "[t]he fact that the overpayments and underpayments relate to different fiscal years does not destroy their logical relationship or indicate that they pertain to separate transactions." *Id.* at 1013. The temporal delay was the inescapable result of a system in which payments were made initially on an estimated basis, subject to "retroactive adjustment" after the necessary audit could be conducted. *Id.* Because the timing had " 'little to do with how one conceptualizes the relation between past overpayments and current compensation due,' " we reasoned that the "timing of the audit is not material to the logical relationship between the overpayments and underpayments." *Id.* (quoting *United States v. Consumer Health Servs. of Am., Inc.*, 108 F.3d 390, 395 (D.C. Cir. 1997)). Given the factual and legal connections between the countervailing obligations, we held that there was a sufficient ***937** logical relationship and that sound equitable considerations supported allowing the Government to invoke recoupment. *Id.* at 1014.

**III**

[16] [17] In this case, California deducted the unpaid HQAF assessments from two separate payment streams: (1) the supplemental payments that the State pays to hospitals out of the fund created by HQAF assessments and (2) the fee-for-service payments that Gardens Regional earned by treating Medi-Cal patients. The bankruptcy court and the BAP found that the deductions from both payment streams qualified as permissible recoupment. We review decisions of the BAP de novo, and we apply the same standard of review to the bankruptcy court's decision that the BAP applied. *Boyajian v. New Falls Corp.* (*In re Boyajian*), 564 F.3d 1088, 1090 (9th Cir. 2009). We review the bankruptcy court's legal conclusions de novo and its factual findings for clear error. *Willms v. Sanderson*, 723 F.3d 1094, 1099 (9th Cir. 2013).

A

[18] We conclude that, in light of the legal and factual connections between Gardens Regional's unpaid HQAF assessments and California's supplemental payments to the hospital, these countervailing obligations have the necessary logical relationship to justify characterizing them as arising from the same transaction for purposes of equitable recoupment.

As explained earlier, the California Legislature first created the HQAF program in order to take advantage of a provision in federal law allowing a State's Medicare plan to make use of certain broad-based health-care-related taxes. *See supra* at 930–31. A central feature of California's HQAF program is that it establishes a "segregated fund[ ]" known as the "Hospital Quality Assurance Revenue Fund" ("HQAR Fund") into which all HQAF proceeds must be deposited, and those HQAF funds may then only be used for specified purposes. Cal. Welf. & Inst. Code §§ 14167.35(a), 14169.50(f)(2). Among those purposes are, *inter alia*, "supplemental Medi-Cal payments to hospitals." *Id.* § 14169.50(f)(2). As a result, there is a direct factual and legal connection between the HQAF payments *into* the segregated HQAR Fund and the supplemental payments made to hospitals *from* that very same segregated fund.

Moreover, the overall linkage between these two streams of money is a critical feature of the HQAF program. Federal law generally does not permit a State to use circular state funding systems (*e.g.*, taxing hospitals only to then pay them back) as a vehicle for increasing federal Medicaid matching payments, but the California HQAF program is specifically tailored to fit within a statutorily created exception to that rule. *See supra* at 930–31. Indeed, California's HQAF statute is explicit in declaring this circular funding mechanism to be a central purpose of the HQAF program: "It is the intent of the Legislature to impose a quality assurance fee *to be paid by hospitals*, which would be used to increase federal financial participation in order to make supplemental Medi-Cal payments *to hospitals*[.]" Cal. Welf. & Inst. Code § 14169.50(d) (emphasis added). This fundamental goal of the HQAF system cannot be achieved unless there is an overall connection between the HQAF assessments paid *by* hospitals *into* the segregated funds and the supplemental payments made *to* hospitals *from* those same funds.

We disagree with Gardens Regional's contention that the necessary logical relationship is missing in light of the fact that, ***938** *in the context of any given hospital*, there is no connection between the specific amount it must pay in HQAF assessments and the specific amounts it receives as supplemental payments. It is true that the two amounts are calculated according to separate, complex formulas,[5] and many hospitals receive supplemental payments without having paid any HQAF assessments.[6] Indeed, Gardens Regional notes that federal law generally *prohibits* any such hospital-specific linkage between the amount of HQAF assessments levied on a particular taxpayer and the amount of any Medicaid payments to that taxpayer. *See* 42 U.S.C. § 1396b(w)(4); 42 C.F.R. § 433.68(f). In our view, however, Gardens Regional's argument that this feature precludes any finding of a logical relationship is foreclosed by *Sims*. In *Sims*, we found the requisite logical connection even though the two payment streams at issue there "relate[d] to different fiscal years" and therefore were independently calculated from one another. 224 F.3d at 1013. We held that this fact did "not destroy [the payments'] logical relationship" because the relevant statutory scheme "create[d] a sufficient relationship" between the separately calculated amounts "to permit recoupment." *Id.* Analogously, the distinctive features of the HQAF program create an essential *overall* linkage between the payment streams into and out of the HQAR Fund, and the resulting countervailing obligations of any individual hospital, even though independently and separately calculated, are sufficiently logically related to permit recoupment.

In view of the strong logical relationship among payment streams that is reflected in these unique features of the HQAF program, we conclude that this "distinctive ... system" of continuously managing hospital payments into segregated

funds against hospital payments out of those same funds is properly treated as "a single transaction for purposes of recoupment." *Sims*, 224 F.3d at 1012. Given these singular features of the HQAF program, it would be " 'inequitable for the debtor to enjoy the benefits of that transaction without meeting its obligations.' " *Newbery*, 95 F.3d at 1403 (citation omitted). And for the same reasons, allowing recoupment in the unique context presented here would not encroach upon, or undermine, the policy judgments reflected in the Bankruptcy Code's limitations on setoffs. *See* 5 Collier on Bankruptcy, *supra*, ¶ 553.10[3]. California therefore properly recouped Gardens Regional's unpaid HQAF assessments into the segregated funds from the HQAF-funded supplemental payments that Gardens Regional was due to receive out of those same funds.

**B**

**[19]** We reach the opposite conclusion with respect to California's deduction of the unpaid HQAF assessments from the fee-for-service payments made to Gardens Regional. Those deductions constitute a ***939** setoff that is subject to the restrictions of the Bankruptcy Code and not a permissible equitable recoupment.

The sorts of legal and factual connections that link the HQAF assessments and the HQAF supplemental payments are simply not present in the distinct context of the State's fee-for-service payments. In contrast to the supplemental payments, the fee-for-service payments are not drawn from the same segregated fund as the HQAF assessments. *See* Cal. Welf. & Inst. Code § 14169.50(f)(2). Nor is there anything comparable to the express statutory policy establishing an overall link between payments into and out of the HQAR Fund in order to accomplish a distinct objective (obtaining greater federal matching funds) that is directly tied to that unique linkage. *See supra* at 937–39. Rather, Gardens Regional earned the fee-for-service payments by providing services to individuals covered by Medi-Cal, and that fee-for-service system was an established part of California's Medi-Cal plan long before the HQAF program, with its segregated funding, was established. *See supra* at 929–31.

Moreover, the fee-for-service payments lack any factual connection to the HQAF assessments comparable to the direct factual link between the countervailing obligations in *Newbery*, both of which arose from the "very same acts" in completing Newbery's projects. 95 F.3d at 1403. And they lack the sort of close connection established by the "specialized and continuous system of estimated payments and subsequent adjustments" we addressed in *Sims*. 224 F.3d at 1012. To recognize a logical relationship between the HQAF assessments and the fee-for-service payments would be to ignore *Sims*'s admonition that "the 'logical relationship' concept is not to be applied so loosely that multiple occurrences in any continuous commercial relationship would constitute one transaction." *Id.*

The State makes two arguments in response, but neither is persuasive. First, California insists that a sufficient logical relationship is created by a provision of the HQAF statute that specifically authorizes the State to deduct unpaid HQAF assessments "from any Medi-Cal payments owed to the hospital, or, in accordance with Section 12419.5 of the Government Code, from any other state payments owed to the hospital." Cal. Welf. & Inst. Code § 14169.52(h). This argument proves too much. As the reference to California Government Code § 12419.5 confirms, this provision of the HQAF statute asserts a broad right to "offset any amount due a state agency from a person or entity"—here, the HQAF assessments—"*against any amount owing that person or entity by any state agency*." Cal. Gov. Code § 12419.5 (emphasis added). Were we to accept California's contention that its statutory assertion of such a sweeping right of setoff *alone* establishes a sufficient logical relationship to warrant recoupment, we would effectively obliterate the distinction between recoupment and setoff and thereby exempt California entirely from the Bankruptcy Code's restrictions on setoffs. To qualify as recoupment, rather than setoff, California's deduction of HQAF fees from fee-for-service payments must rest upon factual and legal connections *beyond* the mere assertion of a statutory right to make such deductions. *See Sims*, 224 F.3d at 1012–13; *Newbery*, 95 F.3d at 1403; *cf. also Malinowski*, 156 F.3d at 134 ("[A] state may not choose to define its rights in a way that defeats the ends of federal bankruptcy law.").

Second, the State argues that the necessary logical relationship between the HQAF assessments and the fee-for-service payments is shown by the fact that they ***940** both are ultimately rooted in Gardens Regional's provider agreement with the State. California notes that that contract, in turn, requires compliance with all applicable state and federal laws, including the broad setoff rights asserted by California in § 14169.52(h). For the reasons we have already explained, California's mere assertion of a broad setoff right—whether by statute or by contract—remains subject to the limitations

of federal bankruptcy law. The recitation of such a setoff right, without more, does not establish that the resulting deduction is actually a *recoupment* for purposes of bankruptcy law.

Nor does anything else about Gardens Regional's standard-form provider agreement supply the necessary logical relationship between the HQAF assessments and the fee-for-service payments. Contrary to what California suggests, we did not hold in *Newbery* that the mere fact that both countervailing obligations were in some sense rooted in the parties' contract was *alone* sufficient to establish the requisite logical relationship. Indeed, such an overbroad proposition would be contrary to *Sims*'s admonition that "the 'logical relationship' concept is not to be applied so loosely that multiple occurrences in any continuous commercial relationship would constitute one transaction." 224 F.3d at 1012; *see also* 5 Collier on Bankruptcy, *supra*, ¶ 553.10[1] ("[T]he mere fact that the relevant obligations arise under a single contract does not automatically mean that recoupment is warranted."). Rather, as explained earlier, in *Newbery* we emphasized that there was also a close *factual* link between the two obligations, because they both arose from the same underlying actions (namely, the completion of the projects that Newbery had abandoned). 95 F.3d at 1403. No such comparable link is present here. The mere fact that both payment streams arise within the overarching context of the larger Medi-Cal program is not enough, and acceptance of such a view would expand the concept of recoupment in a way that would "undermine the fundamental purposes" of the Bankruptcy Code's express limitations on setoffs. *See* 5 Collier on Bankruptcy, *supra*, ¶ 553.10[3].

## IV

We affirm the judgment of the BAP insofar as it holds that California's deduction of unpaid HQAF assessments from the supplemental payments made to Gardens Regional was permissible under the doctrine of equitable recoupment, but we reverse its judgment as to the fee-for-service payments. We remand to the BAP with instructions to remand to the bankruptcy court for further proceedings consistent with this opinion.

**AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.**

### All Citations

975 F.3d 926, Bankr. L. Rep. P 83,571, 20 Cal. Daily Op. Serv. 9818, 2020 Daily Journal D.A.R. 10,179

Footnotes

* The Honorable Joseph F. Bataillon, United States District Judge for the District of Nebraska, sitting by designation.

1 By contrast, under the "managed care" system, the State "contracts with health maintenance organizations ... and other managed care plans to provide health coverage to Medi-Cal beneficiaries, and the plans are paid a predetermined amount for each beneficiary per month, whether or not the beneficiary actually receives services." *Marquez*, 192 Cal. Rptr. 3d at 398 (citing Cal. Welf. & Inst. Code §§ 14204, 14301(a)).

2 Like all Medi-Cal providers, however, Gardens Regional was required to sign a "Provider Agreement," *see* Cal. Welf. & Inst. Code § 14043.2(a), and in Gardens Regional's case that agreement is a standard-form contract issued by the Department.

3 The funds withheld by California constitute the largest contested asset in the bankruptcy estate. As it stands, the State has already recovered approximately 63% of the hospital's HQAF obligation. By contrast, according to Gardens Regional, the hospital's other unsecured creditors are set to receive between 8% and 42% of their claims, with the final percentage depending in large part on whether the money withheld by the State must be returned.

4 After the bankruptcy court subsequently confirmed a plan of liquidation for Gardens Regional, we granted the liquidating trustee's motion to substitute the Gardens Regional Hospital and Medical Center Liquidating Trust as the Appellant.

5 HQAF assessments and supplemental payments are independently calculated on a hospital-by-hospital basis based on technical factors that generally reflect the volume of treatment provided by the hospital to patients. *See, e.g.*, Cal. Welf. & Inst. Code §§ 14169.51(as), 14169.52(a), 14169.54(b), 14169.55(b).

6 HQAF assessments are collected only from private hospitals, including those that do not participate in Medi-Cal, but the resulting funds can be distributed both to private hospitals and to public hospitals that do not pay the HQAF. *See supra* at 930–31. Moreover, HQAF funds are also used for purposes other than supplemental payments to hospitals, such as for providing health coverage for low-income children. Cal. Welf. & Inst. Code §§ 14169.53(b)(1)(B).

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990 F.3d 748
United States Court of Appeals, Third Circuit.

# IN RE: OREXIGEN THERAPEUTICS, INC., Debtor McKesson Corporation; RxC Acquisition Company, Appellants

No. 20-1136
|
Argued November 17, 2020
|
(Filed: March 19, 2021)

**Synopsis**

**Background:** Alleged creditor, which had entered into prepetition services agreement to manage Chapter 11 debtor-drug manufacturer's customer loyalty program, and whose parent company had entered into separate prepetition pharmaceutical distribution agreement with debtor, moved for order determining that it was entitled to disputed funds based on alleged right of setoff that it possessed under state law. The United States Bankruptcy Court for the District of Delaware, Kevin Gross, J., 596 B.R. 9, denied motion. Alleged creditor and its corporate parent appealed. The District Court, Colm F. Connolly, J., 2020 WL 42824, affirmed. Alleged creditor and its corporate parent appealed.

**Holdings:** Addressing issues of first impression for the court, the Court of Appeals, Jordan, Circuit Judge, held that:

[1] mutuality is a distinct and limiting requirement under the setoff provision of the Bankruptcy Code;

[2] mutuality under the Code is limited to debts owing between two parties, and excludes triangular setoffs; and

[3] parent company could not avoid the requirement of mutuality by creatively defining "claim."

Affirmed.

West Headnotes (12)

[1] **Bankruptcy** ⇨ Conclusions of law; de novo review

**Bankruptcy** ⇨ Clear error

Court of Appeals stands in the shoes of the district court and reviews the bankruptcy court's legal conclusions de novo and its factual findings for clear error.

[2] **Bankruptcy** ⇨ Necessity for court approval; discretion

**Bankruptcy** ⇨ Proceedings

In action brought under setoff provision of the Bankruptcy Code, elements of the bankruptcy court's setoff decision are within its discretion, although the legal standards it applies are not. 11 U.S.C.A. § 553.

[3] **Bankruptcy** ⇨ Set-off or recoupment in general

To assert a setoff exception under the setoff provision of the Bankruptcy Code, a right to setoff must exist under applicable state law. 11 U.S.C.A. § 553.

[4] **Bankruptcy** ⇨ Mutuality; identity of right, person, and capacity

Mutuality is a distinct and limiting requirement under the setoff provision of the Bankruptcy Code. 11 U.S.C.A. § 553.

1 Cases that cite this headnote

[5] **Bankruptcy** ⇨ Mutuality; identity of right, person, and capacity

Under the setoff provision of the Bankruptcy Code, which allows parties to invoke setoff rights when the debts they owe one another are mutual, mutuality is limited to debts owing between two parties, specifically, those owing from a creditor directly to the debtor and, in turn,

owing from the debtor directly to that creditor; mutuality excludes any contractual elaboration on that kind of simple, bilateral relationship, such as triangular setoffs. 11 U.S.C.A. § 553.

1 Cases that cite this headnote

[6] **Bankruptcy** ⇦ Set-off or recoupment in general

Setoff is at odds with a fundamental policy of bankruptcy, equality among creditors, because it permits a creditor to obtain full satisfaction of a claim by extinguishing an equal amount of the creditor's obligation to the debtor; in effect, the creditor receives a preference. 11 U.S.C.A. § 553.

[7] **Bankruptcy** ⇦ Mutuality; identity of right, person, and capacity

"Triangular setoffs," in which party A owes party B who next owes party C who then owes party A, are definitionally not "mutual" within meaning of Bankruptcy Code's setoff provision, which allows parties to invoke setoff rights when the debts they owe one another are mutual. 11 U.S.C.A. § 553.

[8] **Bankruptcy** ⇦ Mutuality; identity of right, person, and capacity

Although parties may freely contract for triangular setoff rights, they may not do so in derogation of the mandates of the Bankruptcy Code. 11 U.S.C.A. § 553.

1 Cases that cite this headnote

[9] **Bankruptcy** ⇦ Mutuality; identity of right, person, and capacity

If company that entered into prepetition pharmaceutical distribution agreement with Chapter 11 debtor-drug manufacturer wanted, for setoff purposes, "mutuality" for debts arising from that agreement as well as for debts arising from prepetition services agreement that its wholly-owned subsidiary entered into with debtor to manage debtor's customer loyalty program, company should have taken on the customer loyalty support itself, instead of having its subsidiary handle it for debtor and then relying on triangular debt arrangement set forth in "setoff provision" of distribution agreement. 11 U.S.C.A. § 553.

[10] **Bankruptcy** ⇦ Mutuality; identity of right, person, and capacity

If company that entered into prepetition pharmaceutical distribution agreement with Chapter 11 debtor-drug manufacturer wanted its wholly-owned subsidiary, which entered into prepetition services agreement with debtor to manage debtor's customer loyalty program, to have a perfected security interest in debtor's account receivable due from company, company should have taken steps to arrange that, instead of relying on triangular debt arrangement set forth in "setoff provision" of distribution agreement; by perfecting a security interest, subsidiary may have obtained a priority right to the same amount company subsequently sought via setoff, which would have had added benefit of placing debtor's other creditors on advance notice of that priority claim. 11 U.S.C.A. §§ 507, 553.

[11] **Bankruptcy** ⇦ Mutuality; identity of right, person, and capacity

Company that had entered into prepetition pharmaceutical distribution agreement with Chapter 11 debtor-drug manufacturer, and whose wholly-owned subsidiary had entered into prepetition services agreement with debtor to manage debtor's customer loyalty program, could not avoid the requirement of "mutuality" for setoff under the Bankruptcy Code by creatively defining "claim," that is, by arguing that, instead of a triangular debt arrangement, it actually held a two-sided direct claim against debtor under distribution agreement's setoff provision, with, on the one side, the account receivable that it owed to debtor, and on the other side the setoff provision of the distribution agreement; trying to offset a debt against a setoff

 

right struck court as nonsense. 11 U.S.C.A. § 553.

[12] **Bankruptcy** ⇦ Set-off against claim

Because the word "setoff" means to subtract, the term "claim," at least in the context of the Bankruptcy Code's setoff provision, which allows a creditor to offset a mutual debt owing by such creditor to the debtor that arose before commencement of the bankruptcy case against a claim of such creditor against the debtor that arose before commencement of the case, must be limited to the types of claims that connote a positive rather than negative value. 11 U.S.C.A. § 553.

On Appeal from the United States District Court for the District of Delaware (D.C. No.1-18-cv-01873), District Judge: Hon. Colm F. Connolly

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Before: JORDAN, KRAUSE, and RESTREPO, Circuit Judges

OPINION OF THE COURT

JORDAN, Circuit Judge.

This dispute turns on the meaning of the word "mutual" in the provision of the Bankruptcy Code that allows parties to invoke setoff rights when the debts they owe one another are mutual. *See* 11 U.S.C. § 553.

McKesson Corporation, Inc. ("McKesson") and Orexigen Therapeutics, Inc. ("Orexigen") agreed to a pharmaceutical distribution deal and included a provision in their contract whereby McKesson, as distributor of the drug, could reduce what it owed to Orexigen, the drug manufacturer, by any amount that Orexigen owed to McKesson or any McKesson subsidiary. Shortly thereafter, one of those subsidiaries, McKesson Patient Relationship Solutions ("MPRS"),[1] separately agreed to help Orexigen with a consumer discount program by advancing cash to pharmacies, with Orexigen then obligated to reimburse MPRS. Later, when Orexigen filed for bankruptcy, it owed MPRS approximately $9 million, and McKesson owed Orexigen approximately $7 million. The Bankruptcy Court and the District Court rejected McKesson's request to set off its debt by the amount Orexigen owed MPRS, which would have reduced MPRS's claim to approximately $2 million and McKesson's debt to zero. Both courts held that what McKesson wanted was a triangular setoff, not a mutual one, and thus was not the kind allowable under § 553 of the Bankruptcy Code. We agree and will affirm.

## I. BACKGROUND

Orexigen was a publicly traded pharmaceutical company whose only commercial product was a weight management drug called Contrave. On June 9, 2016, Orexigen entered into a "Distribution Agreement" with McKesson, whereby Orexigen sold Contrave to McKesson, and McKesson in turn provided the drug to pharmacies. Included in the Distribution Agreement was a "Setoff Provision" that permitted "each of [McKesson] and its affiliates ... to set-off, recoup and apply any amounts owed by it to [Orexigen's] affiliates against any [and] all amounts owed by [Orexigen] or its affiliates to any of [McKesson] or its affiliates." (App. at 13.)

Separate from the Distribution Agreement, MPRS and Orexigen entered into a "Services Agreement" on July 5, 2016. Under the Services Agreement, MPRS managed a customer loyalty program for Orexigen, pursuant to which patients would receive price discounts from pharmacies. MPRS would advance funds to pharmacies selling Contrave, with reimbursement arriving later from Orexigen. The Distribution Agreement and Services Agreement did not

reference, incorporate, or integrate one another, and the parties agree that McKesson and MPRS were distinct legal entities.

By the time Orexigen filed its petition for Chapter 11 relief on March 12, 2018 (the "Petition Date"), it owed MPRS approximately $9.1 million under the Services Agreement, and McKesson owed Orexigen some $6.9 million under the Distribution Agreement.[2] Had there been a setoff of those obligations pursuant to the Setoff Provision, Orexigen would have owed MPRS $2.2 million and McKesson would have owed Orexigen nothing.

On March 16, 2018, four days after the Petition Date, Orexigen filed a motion to sell substantially all of its assets for $75 million in cash. McKesson objected to the asset sale, and, following that objection, the parties negotiated for McKesson to pay the approximately $6.9 million receivable it owed to Orexigen, while Orexigen agreed to keep that sum segregated pending resolution of the setoff dispute.[3]

McKesson and MPRS then asked the Bankruptcy Court to decide their rights to the segregated funds under the Setoff Provision in the Distribution Agreement and § 553 of the Code.[4] The Court rejected McKesson's argument for a setoff because, while the Setoff Provision constituted an "enforceable contractual right allowing a parent and its subsidiary corporation to [e]ffect a prepetition triangular setoff under state law[,]" that relationship "does not supply the strict mutuality required in bankruptcy." *In re Orexigen Therapeutics, Inc.*, 596 B.R. 9, 12 (Bankr. D. Del. 2018).[5]

The Bankruptcy Court went on to discuss the meaning of mutuality, relying on its own precedent in a case called *In re SemCrude* to conclude that § 553 "is strictly construed against the party seeking setoff." *Id.* at 17 (citing *In re SemCrude, L.P.*, 399 B.R. 388, 396 (Bankr. D. Del. 2009) (citation omitted)). It held, as it had in *SemCrude*, that contracts cannot turn nonmutual debts into debts subject to setoff under the Code, as if they had been mutual. *See id.* at 18. The Court rejected McKesson's argument that mutuality merely "identifies the state-law right that is thereby preserved unaffected in bankruptcy." (Opening Br. at 14.) It further rejected the notion that MPRS's alleged status as a third-party beneficiary of the Distribution Agreement created mutuality. *See In re Orexigen Therapeutics, Inc.*, 596 B.R. at 22–23. The Court saw those arguments as attempts to "contract around section 553(a)'s mutuality requirement." *Id.* at 21.

As was its right under § 365 of the Code, Orexigen rejected the Distribution Agreement and the Services Agreement, and the Bankruptcy Court then confirmed Orexigen's plan for liquidation.[6] McKesson appealed the Bankruptcy Court's mutuality decision to the District Court, which affirmed. This timely appeal followed.

## II. DISCUSSION[7]

Section 553 of the Bankruptcy Code says that, "[e]xcept as otherwise provided ..., this title does not affect any right of a creditor to offset a *mutual* debt owing by such creditor to the debtor ... against a claim of such creditor against the debtor[.]" 11 U.S.C. § 553(a) (emphasis added). The meaning of mutuality in that provision is a matter of first impression for us. And while our sister circuits have opined on the importance of mutuality as a distinct limitation of § 553, they have not ruled on whether a contract can create an exception to the requirement of direct mutuality. Our task is to understand what Congress meant in using the term "mutual" in that Code section.

Orexigen asks us to adopt the reasoning of a unanimous line of authority from bankruptcy courts, beginning with *SemCrude*, that requires strict bilateral mutuality for § 553 to apply. McKesson, on the other hand, argues that *SemCrude* and the cases that follow it should be upended because the word "mutual" in § 553 is merely a non-limiting adjective meant to invoke an understanding of how state law setoff rights generally operate. We conclude that the analysis set forth in *SemCrude* is sound and the Bankruptcy Court and District Court here rightly treated mutuality as a distinct statutory requirement under § 553.

### A. The Term "Mutual" in § 553 Imposes a Distinct Limitation

**[3]** **[4]** The parties agree, as an initial matter, that to assert a setoff exception under § 553, a right to setoff must exist under applicable state law.[8] Their disagreement begins with McKesson's contention that both the general right to enforce a setoff and the requisite mutuality are defined by state law, with § 553 imposing no independent mutuality limitation. In other words, McKesson contends that the term "mutual" is nothing more than a "definitional scope provision that identifies the state-law right that is thereby preserved unaffected in bankruptcy[.]" (Opening Br. at 14.) Orexigen argues in response that the modifier "mutual," as used in §

553, imposes a distinct limitation strictly construed to prohibit enforcement of a setoff agreement involving three or more parties and indirect debt obligations.

As the *SemCrude* court noted, a compelling body of precedent, including from this Court, treats mutuality in § 553 as a limiting term, not a redundancy. *See In re SemCrude, L.P.*, 399 B.R. at 393 (collecting cases).[9] McKesson tries to rebut the import of those cases by pointing out that § 553 includes three expressly enumerated federal exceptions to the right to enforce a setoff, and an exception focused on non-mutual debts is not among them.[10] It argues that Congress would have included an enumerated exception bearing on mutuality if it had intended that concept to serve as a limitation under federal law rather than a term simply descriptive of state law.

Orexigen has the better of the argument, however, because McKesson's reading of the statute would render the term "mutual" redundant, as the phrase "any right ... to offset" provides adequate definitional scope to § 553. To reiterate, the operative language reads "this title does not affect *any right of a creditor to offset a mutual debt*." 11 U.S.C. § 553(a) (emphasis added). Moreover, the text immediately following that language, although not enumerated, provides a limiting effect on the enforceability of § 553 by stating that both the debtor's claim against the creditor and the creditor's claim against the debtor must "ar[i]se before the commencement of the case." *Id.* That requirement is consistently viewed as a distinct limitation on the ability to assert a setoff right, and there is no persuasive reason to treat the requirement of mutuality any differently.[11]

**B. Mutuality Under § 553 Excludes Triangular Setoffs, Including the Setoff Provision in the Distribution Agreement**

**[5]** Having determined that mutuality is a distinct and limiting requirement of federal bankruptcy law, we next consider the effect of that limitation. We again agree with and adopt the *SemCrude* court's well-reasoned conclusion that Congress intended for mutuality to mean only debts owing between two parties, specifically those owing from a creditor directly to the debtor and, in turn, owing from the debtor directly to that creditor. Congress did not intend to include within the concept of mutuality any contractual elaboration on that kind of simple, bilateral relationship.

**[6]** **[7]** Given basic premises of the Bankruptcy Code, that is not surprising. "[S]etoff is at odds with a fundamental policy of bankruptcy, equality among creditors, because it permits a creditor to obtain full satisfaction of a claim by extinguishing an equal amount of the creditor's obligation to the debtor, i.e., in effect, the creditor receives a preference." *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 57 (3d Cir. 1990) (internal quotation marks and citation omitted). Thus, we and our sister circuits have indicated that triangular setoffs – in which party A owes party B who next owes party C who then owes party A – are definitionally not mutual. *See id.* at 59 ("To be mutual, the debts must be in the same right and between the same parties, standing in the same capacity.") (citation omitted); *In re United Sciences of Am., Inc.*, 893 F.2d 720, 723 (5th Cir. 1990) ("The requirement of mutuality is 'that each party ... own his claim in his own right severally, with the right to collect in his own name [and] in his own right and severally.' ") (citation omitted); *MNC Commercial Corp. v. Joseph T. Ryerson & Son, Inc.*, 882 F.2d 615, 618 n.2 (2d Cir. 1989) ("[A] subsidiary's debt may not be set off against the credit of a parent."); *In re Elcona Homes Corp.*, 863 F.2d 483, 486 (7th Cir. 1988) ("[T]he statute itself speaks of '*a mutual debt*[.]' ").

That should end the matter, but McKesson insists that its Setoff Provision in the Distribution Agreement turns the debts between Orexigen and MPRS and between McKesson and Orexigen from a triangular debt arrangement into a mutual debt. The error of that assertion is described in *SemCrude*.[12]

There, a contract like the Distribution Agreement at issue here created the right to set off debts owed by the creditor or its affiliates against debts owed by the debtor or its affiliates. *SemCrude*, 399 B.R. at 391. The court gave that agreement careful consideration but rightly recognized that contractual arrangements cannot transform a triangular set of obligations into bilateral mutuality. The mutuality requirement set a limit, and "[t]he effect of [mutuality's] narrow construction is that 'each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally.' " *Id.* at 396 (quoting *In re Garden Ridge Corp.*, 338 B.R. 627, 633–34 (Bankr. D. Del. 2006), *aff'd*, 399 B.R. 135 (D. Del. 2008), *aff'd*, 386 F. App'x 41 (3d Cir. 2010)). In the end, "mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff." *Id.* at 397. The court noted in its statutory interpretation that, "[i]n articulating exactly who must owe whom a debt to effect a setoff under [§] 553(a), Congress used a greater detail of precision than is seen in many other parts of the Code." *Id.* Moreover, the policies of the Code disfavor a contractual exception to mutuality. In particular, "[o]ne of the primary

goals—if not the primary goal—of the Code is to ensure that similarly-situated creditors are treated fairly and enjoy an equality of distribution from a debtor absent a compelling reason to depart from this principle." *Id.* at 399. Triangular setoffs undermine that goal.

**[8]** The reasoning of *SemCrude* has been frequently relied on in other bankruptcy cases, including this one.[13] In embracing the *SemCrude* analysis, the Bankruptcy Court for the Southern District of New York succinctly explained that "mutuality quite literally is tied to the identity of a particular creditor that owes an offsetting debt. The right is personal, and there simply is no ability to get around this language [of § 553]. Parties may freely contract for triangular setoff rights, but not in derogation of these mandates of the Bankruptcy Code." *In re Lehman Bros. Inc.*, 458 B.R. 134, 141 (Bankr. S.D.N.Y. 2011). We agree.[14]

**[9]** **[10]** If McKesson wanted mutuality for the debts in question, it should have taken on the customer loyalty support that it instead had its subsidiary MPRS handle for Orexigen. Alternatively, if McKesson wanted MPRS to have a perfected security interest in Orexigen's account receivable due from McKesson, it should have taken steps to arrange that. By perfecting a security interest, MPRS may have obtained a priority right to the same amount McKesson now seeks via setoff, which would have had the added benefit of placing Orexigen's other creditors on advance notice of that priority claim. *See* U.C.C. § 9-301 (to perfect a lien on property, the owner must file a disclosure according to the rules of the local jurisdiction); 11 U.S.C. § 507 (prioritizing claims secured by a lien over unsecured claims); *In re Elcona Homes Corp.*, 863 F.2d at 486 (noting that "the recognition by state law of a right of set off makes the set off a form of secured financing"); *Oneida Motor Freight, Inc. v. United Jersey Bank*, 848 F.2d 414, 416 (3d Cir. 1988) ("A long-standing tenet of bankruptcy law requires one seeking benefits under its terms to satisfy a companion duty to schedule, for the benefit of creditors, all his interests and property rights." (citation omitted)). McKesson's desired outcome, wherein contractual setoff agreements can shoehorn multiparty debts into § 553, would disincentivize public disclosure of prioritized claims, weakening a fundamental purpose of the Code.

In contrast, a rule that excludes nonmutual debts from the setoff privilege of § 553 promotes predictability in credit transactions. *See* Megan McDermott, *Justice Scalia's Bankruptcy Jurisprudence: The Right Judicial Philosophy for the Modern Bankruptcy Code?*, 2017 UTAH L. REV. 939, 953 (2017) (arguing that "rule-based textualism is particularly advantageous for the bankruptcy field" because of "the inefficient nature of bankruptcy litigation" and "the central role bankruptcy law plays in commercial markets"). An unambiguous rule regarding the scope of § 553 maximizes the payout for all parties by avoiding litigation expenses. *See* The Honorable Thomas F. Waldron & Neil M. Berman, *Principled Principles of Statutory Interpretation: A Judicial Perspective After Two Years of BAPCPA*, 81 AM. BANKR. L.J. 195, 213 (2007) ("In a bankruptcy proceeding where assets seldom exceed liabilities, and every dollar applied to costs and fees – attorneys, trustees, committees, and others – is a dollar not available for distribution to creditors, consistency in statutory interpretation takes on additional significance[.] ... Consistent application of the principles of statutory interpretation is a necessary element in a court's attempt to provide predictability.").

### C. McKesson's Attempt to Creatively Define the Term "Claim" Does Not Avoid the Requirements of Mutuality Under § 553

**[11]** In the alternative, McKesson argues that it actually holds a direct claim against Orexigen under the Setoff Provision of the Distribution Agreement. It tries to frame its requested setoff as effectively being two-sided: on one side, it argues, is the account receivable owed by McKesson to Orexigen, and on the other side is the Setoff Provision of the Distribution Agreement. Again, the *SemCrude* court faced just such an argument and persuasively rejected the attempt to escape triangularity by redefining what constitutes a "claim" under § 553. *See In re SemCrude, L.P.*, 399 B.R. at 397 ("An agreement to setoff funds, such as the one claimed by Chevron in this case, does not give rise to a debt that is 'due to' Chevron and 'due from' SemCrude. ... Likewise, Chevron does not have a 'right to collect' against SemCrude under the agreement in this case."). We follow suit.

**[12]** McKesson's position is nothing but a recasting of its failed effort to defeat the purpose and meaning of § 553. It focuses on the definition of the term "claim" in isolation and ignores the rest of § 553, which necessarily refines the term's meaning. If McKesson's definition of claim were to be inserted in this context, § 553 would state that "this title does not affect any right of a creditor to offset a mutual debt ... against [a setoff right] of such creditor." Trying to offset a debt against a setoff right strikes us as nonsense.[15] Accordingly, we reject McKesson's interpretation of the term "claim" in the context of § 553. "At bottom, [McKesson] may enjoy privity

of contract with [Orexigen], but it lacks the mutuality required by the plain language of [§] 553."[16] *In re SemCrude, L.P.*, 399 B.R. at 397.

## III. CONCLUSION

For the foregoing reasons, we will affirm the order of the District Court that affirmed the Bankruptcy Court's ruling.

**All Citations**

990 F.3d 748

Footnotes

1 MPRS later merged into RxC Acquisition Company, a named Appellant, which is also a subsidiary of McKesson.

2 Orexigen says there is a dispute over the amount Orexigen owes MPRS, claiming the proof of claim only establishes $8,564,075.68 due. The Bankruptcy Court held, and we agree, that the precise amount is not material to the legal questions presented.

3 The segregated $6.9 million is currently held by Province, Inc., which, as the administrator of the bankruptcy estate, has taken control of Orexigen's remaining assets pursuant to the confirmed liquidation plan.

4 Section 553 reads: "Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case[.]" 11 U.S.C. § 553(a). Three enumerated exceptions follow. Section 553 uses the terms "offset" and "setoff," while the parties often use the term "setoff." Viewing these as synonyms, we generally use the latter herein, as that is the language used in documents at issue in the case.

5 The Bankruptcy Court assumed without deciding that the parties had an enforceable prepetition right to setoff under California law. *See In re Orexigen Therapeutics, Inc.*, 596 B.R. at 15. It noted that, although the parties disputed whether McKesson was a creditor within the meaning of § 553, they did not substantially brief the issue, so it deemed McKesson a creditor such that it could pursue its setoff claim, particularly in light of the parties' stipulation to preserve the disputed assets. *See id.* at 16.

6 Section 365 states: "Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a).

7 **[1]** **[2]** The Bankruptcy Court had jurisdiction under 28 U.S.C. §§ 1334(b), 157(a) and 157(b)(1). We have jurisdiction over this appeal pursuant to 28 U.S.C. § 158(d)(1). We " 'stand in the shoes' of the District Court and ... review the Bankruptcy Court's legal conclusions *de novo* and its factual findings for clear error." *In re Global Indus. Techs., Inc.*, 645 F.3d 201, 209 (3d Cir. 2011) (en banc) (citations omitted). Elements of the Bankruptcy Court's setoff decision are within its discretion, although the legal standards it applies are not. *See In re Garden Ridge Corp.*, 399 B.R. 135, 139 (D. Del. 2008) (citing *In re United Healthcare Sys., Inc.*, 396 F.3d 247, 249 (3d Cir. 2005)); *In re Gould*, 401 B.R. 415, 429 (9th Cir. BAP 2009).

8 They are correct. *See United States ex rel. IRS v. Norton*, 717 F.2d 767, 772 (3d Cir. 1983) ("[Section 553] is not an independent source of law governing setoff; it is generally understood as a legislative attempt to preserve the common-law right of setoff arising out of non-bankruptcy law" and "the courts below were correct in looking to state law to determine when a setoff has occurred."); *see also Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18, 116 S.Ct. 286, 133 L.Ed.2d 258 (1995).

9 *See In re Univ. Med. Ctr.*, 973 F.2d 1065, 1079 (3d Cir. 1992) ("The doctrine of setoff ... gives a creditor the right 'to offset a mutual debt owing by such creditor to the debtor,' provided that both debts arose before commencement of the bankruptcy action and are in fact mutual.") (citation omitted); *see also PACA Tr. Creditors of Lenny Perry's Produce, Inc. v. Genecco Produce Inc.*, 913 F.3d 268, 277 n.4 (2d Cir. 2019) ("[T]he U.S. Bankruptcy Code ... makes offsets available only for 'mutual' debts."); *In re Meyer Med. Physicians Grp., Ltd.*, 385 F.3d 1039, 1041 (7th Cir. 2004) ("Mutuality requires that the debt in question be owed in the same right and between the same parties standing in the same capacity[.]"); *In re Myers*, 362 F.3d 667, 672 (10th Cir. 2004) ("Under § 553, a creditor with an independent right of setoff may setoff a debtor's obligations only if the creditor satisfies three elements.... Third, the creditor's and debtor's obligations must be mutual."); *In re Verco Indus.*, 704 F.2d 1134, 1139 (9th Cir. 1983) ("The timing and mutuality elements must both be satisfied to establish a set-off under [§ 553].").

10 Those enumerated exceptions are: "(1) the claim of such creditor against the debtor is disallowed; (2) such claim was transferred, by an entity other than the debtor, to such creditor ... after the commencement of the case; or ... after 90 days before the date of the filing of the petition; and ... while the debtor was insolvent ... or (3) the debt owed to the debtor by such creditor was incurred by such creditor – after 90 days before the date of the filing of the petition; while the debtor was insolvent; and for the purpose of obtaining a right of setoff against the debtor[.]" 11 U.S.C. § 553(a)(1)–(3).

11 *See In re Garden Ridge Corp.*, 338 B.R. 627, 633 (Bankr. D. Del. 2006); *In re James River Coal Co.*, 534 B.R. 666, 669–70 (Bankr. E.D. Va. 2015); *In re Am. Home Mortg. Holdings, Inc.*, 501 B.R. 44, 56 (Bankr. D. Del. 2013); *In re Sentinel Prods. Corp.*, 192 B.R. 41, 45 (N.D.N.Y. 1996); *In re Westchester Structures, Inc.*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995); *In re Woodside Grp., LLC*, No. 6:08-bk-20682, 2009 WL 6340015, at *4 (Bankr. C.D. Cal. Dec. 30, 2009).

12 *SemCrude* traced the history of attempts to create a contractual exception to strict mutuality, through dicta in various decisions, back to a single case, *In re Berger Steel Co.*, 327 F.2d 401 (7th Cir. 1964), now almost 60 years old. But even *Berger* had not actually authorized such an exception. In *Berger*, a creditor sought a priority interest in a sum of money which the debtor owed to a subsidiary of that creditor, pursuant to an alleged setoff agreement between the three parties. *See id.* at 401–04. The Court did not reach whether such a "tripartite agreement" could be enforced under the predecessor to § 553, instead merely affirming the District Court's ruling that no such contract even existed. *See id.* at 405–06. As explained in *SemCrude*, it "avoided addressing the ... question of whether a triangular setoff was permissible under the Bankruptcy Act if a contract signed by the parties to the proposed setoff contemplated such a remedy." 399 B.R. at 395. Thus, there is no authority supporting a contractual exception to the mutuality requirement of § 553. *See id.* at 396–99.

13 *See In re Orexigen Therapeutics, Inc.*, 596 B.R. at 16–22; *In re Pursuit Capital Mgmt., LLC*, 595 B.R. 631, 659 n.124 (Bankr. D. Del. 2018); *Carn v. Heesung PMTech Corp.*, 579 B.R. 282, 294–95 (M.D. Ala. 2017); *In re TSAWD Holdings, Inc.*, 565 B.R. 292, 301 (Bankr. D. Del. 2017); *In re: All Phase Steel Works, LLC*, No. 3:16-cv-00844, 2016 WL 6208252, at *5 (D. Conn. Oct. 24, 2016); *In re Arcapita Bank B.S.C.(c)*, No. 12-11076, 2014 WL 2109931, at *3 (Bankr. S.D.N.Y. May 20, 2014); *In re Am. Home Mortg. Holdings, Inc.*, 501 B.R. at 55; *In re Direct Response Media, Inc.*, 466 B.R. 626, 658 (Bankr. D. Del. 2012).

14 This view of § 553 is completely consistent with the cases cited by McKesson where courts have found mutuality despite one end of the mutual debts being joint and several, such as a chargeback right held by a bank against all its customers. In all of those cases the debts are still directly owing between the debtor and creditor. *See, e.g., In re United Sciences of Am., Inc.*, 893 F.2d at 723 ("[W]hen First City exercised its contractual right to debit USA's account for chargebacks paid to the issuing banks, it asserted this claim ... in its own name and in its own right, regardless of whether it was in fact a surety or an indemnitee of USA."); *In re Diplomat Elec., Inc.*, 499 F.2d 342, 348 (5th Cir. 1974) ("The courts have uniformly interpreted Section 68[, the predecessor to § 553,] of the Bankruptcy Act as did the court below whenever joint and several obligations have been urged as a bar to mutuality." (citation omitted)); *In re Sherman Plastering Corp.*, 346 F.2d 492, 493 (2d Cir. 1965) ("The sureties were explicitly held jointly liable (a point much stressed by appellant although we can perceive no difference here relevant between a joint and several liability)."); *In re Calstar, Inc.*, 159 B.R. 247, 256 (Bankr. D. Minn. 1993) (explaining that chargebacks between a debtor's debit account and a bank are "a series of classic setoffs"); *In re Classic Roadsters, Ltd.*, No. 92-30914, 1993 WL 1623209, at *7–9 (Bankr. D.N.D. Apr. 13, 1993) (finding mutuality satisfied by a chargeback agreement between consumers and a bank).

15 The word "setoff" means to subtract, so the term "claim," at least in the context of § 553, must be limited to the types of claims that connote a positive rather than negative value, because when one subtracts a negative one is performing addition.

16 Having held in favor of Orexigen on the meaning and application of mutuality in § 553, we do not reach its remaining arguments.

End of Document

604 B.R. 154
United States Bankruptcy Court, D. Delaware.

IN RE: THG HOLDINGS LLC, et al., Debtors.
True Health Diagnostics LLC, Plaintiff(s),
v.
Alex M. Azar, II, in his capacity as Secretary, United States Department of Health and Human Services; Seema Verma, in her official capacity as Administrator, Centers for Medicare and Medicaid Services, Defendant(s),

Case No. 19-11689 (JTD)
|
Adv. Proc. No. 19-50280 (JTD)
|
Signed August 29, 2019

**Synopsis**

**Background:** Chapter 11 debtor limited liability company (LLC), a laboratory provider of diagnostic and disease management solutions, brought adversary proceeding seeking to enforce the automatic stay in connection with Centers for Medicare and Medicaid Services's (CMS) withholding Medicare payments.

**Holdings:** The Bankruptcy Court, John T. Dorsey, J., held that:

[1] bankruptcy court properly had jurisdiction over debtor's claims even though debtor did not exhaust administrative remedies pursuant to Medicare statute;

[2] postpetition Medicare reimbursements for medical tests performed by debtor postpetition were property of the estate; and

[3] CMS's withholding postpetition Medicare payments did not fall within police power exception to the automatic stay.

Ordered accordingly.

See also, *True Health Diagnostics, LLC v. Azar*, 2019 WL 3308203.

West Headnotes (23)

[1] **Bankruptcy** ⇨ Stay enforcement
**Health** ⇨ Exhaustion of administrative remedies

Chapter 11 debtor's adversary proceeding, alleging that Centers for Medicare and Medicaid Services (CMS) violated automatic stay by withholding Medicare payments postpetition for medical tests performed by debtor postpetition based upon alleged prepetition overpayments, arose under Bankruptcy Code and not under Medicare statute, and thus bankruptcy court properly had jurisdiction over debtor's claims even though debtor did not exhaust administrative remedies pursuant to Medicare statute; narrow question before the bankruptcy court of whether CMS was in violation of the automatic stay was not inextricably intertwined with prepetition fiscal reimbursement determinations, rather, those issues would be addressed through the administrative process and that process would determine the amount, if any, of CMS's prepetition unsecured claim. 11 U.S.C.A. § 362; 28 U.S.C.A. §§ 157, 1334; 42 U.S.C.A. §§ 405(h), 1395ii.

[2] **Bankruptcy** ⇨ Automatic Stay

The automatic stay is one of the most fundamental protections provided by the Bankruptcy Code, giving the debtor a breathing spell from its creditors. 11 U.S.C.A. § 362.

[3] **Bankruptcy** ⇨ Proceedings, Acts, or Persons Affected

The scope of the automatic stay is very broad, and applies to any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the

estate, and any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case. 11 U.S.C.A. § 362.

[4] **Bankruptcy** ⇦ Legal or equitable interests in general

Property of the bankruptcy estate includes all legal or equitable interests of the debtor in property as of the commencement of the case. 11 U.S.C.A. § 541(a)(1).

[5] **Bankruptcy** ⇦ Property of Estate in General

"Property of the estate" sweeps broadly to include all property whether tangible, intangible, contingent, or postponed. 11 U.S.C.A. § 541(a)(1).

[6] **Bankruptcy** ⇦ Future interests

The mere opportunity to receive an economic benefit in the future is "property" with value under the Bankruptcy Code. 11 U.S.C.A. § 541(a)(1).

1 Cases that cite this headnote

[7] **Bankruptcy** ⇦ Automatic Stay

The automatic stay is designed to halt all collection efforts in order to allow the debtor time to reorganize. 11 U.S.C.A. § 362.

[8] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

The automatic stay applies to all "entities," including the government when acting as a creditor. 11 U.S.C.A. §§ 101(15), 362.

[9] **Bankruptcy** ⇦ Property held in trust or custody for debtor; deposits

Postpetition Medicare reimbursements for medical tests performed by Chapter 11 debtor postpetition were property of the estate; debtor received the reimbursements throughout the ordinary course of its business in exchange for its services as a healthcare provider, and while those payments were being escrowed pending overpayment determinations, they were merely postponed payments that debtor expected to receive. 11 U.S.C.A. § 541.

[10] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

The police power exception is the only governmental exception to the automatic stay, providing that the stay does not apply to actions to enforce such governmental unit's police and regulatory power. 11 U.S.C.A. § 362(b)(4).

[11] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

The police power exception to the automatic stay is intended to discourage debtors from using the bankruptcy process to evade governmental efforts to invoke its police powers to enjoin or deter ongoing debtor conduct which would seriously threaten the public safety and welfare. 11 U.S.C.A. § 362(b)(4).

[12] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

To determine whether a governmental unit's actions fall within the police power exception to the automatic stay, courts apply two overlapping tests: the pecuniary interest and public policy tests. 11 U.S.C.A. § 362(b)(4).

[13] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

The pecuniary interest test for determining whether a governmental unit's actions fall within the police power exception to the automatic stay asks whether the government primarily seeks to protect a pecuniary governmental interest in the debtor's property. 11 U.S.C.A. § 362(b)(4).

[14] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

The public policy test for determining whether a governmental unit's actions fall within the police power exception to the automatic stay asks whether the government is enforcing public policy as opposed to private rights. 11 U.S.C.A. § 362(b)(4).

[15] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

If the purpose of a law is to promote public safety and welfare or to effectuate public policy, then the police power exception to the automatic stay applies. 11 U.S.C.A. § 362(b)(4).

[16] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

If the purpose of a law is to protect the government's pecuniary interest in the debtor's property or primarily to adjudicate private rights, then the police power exception to the automatic stay is inapplicable. 11 U.S.C.A. § 362(b)(4).

[17] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

The purpose of the pecuniary interest and public policy tests for determining whether a governmental unit's actions fall within the police power exception to the automatic stay is to get to the heart of the reasoning behind the government's actions to avoid relying on unsupported statements of intent. 11 U.S.C.A. § 362(b)(4).

[18] **Bankruptcy** ⇦ Administrative Proceedings and Governmental Action

Centers for Medicare and Medicaid Services's (CMS) withholding of Medicare payments postpetition for medical tests performed by Chapter 11 debtor postpetition based upon alleged prepetition overpayments did not fall within police power exception to the automatic stay; nothing in the record suggested CMS's withholding of the postpetition Medicare payments was for any purpose other than protecting its pecuniary interest in property of the estate over the interests of other unsecured creditors and nothing suggested that CMS's actions were an effort to enforce public policy, and there was no evidence that debtor engaged in fraud postpetition or that there had been any overpayments postpetition, rather, CMS stated that all the alleged fraud and overpayments occurred before the petition date. 11 U.S.C.A. § 362(b)(4).

[19] **Bankruptcy** ⇦ Notice to creditors; commencement

The automatic stay is self-executing, effective upon the filing of the bankruptcy petition. 11 U.S.C.A. § 362.

[20] **Bankruptcy** ⇦ Enforcement of Injunction or Stay

There is no need for debtor to show irreparable harm for the automatic stay to apply. 11 U.S.C.A. § 362.

[21] **Bankruptcy** ⇦ Automatic Stay

Bankruptcy Code provision governing automatic stay does not impose a requirement that the balance of the equities favors the debtor, nor that imposition of the stay is in the public interest; indeed, requiring such a showing would read into the provision requirements for application of the stay that Congress did not provide for in the Code. 11 U.S.C.A. § 362.

[22] **Injunction** ⇦ Grounds in general; multiple factors

Court must consider the following factors in deciding whether to grant a preliminary injunction: (1) likelihood that the plaintiff will prevail on the merits, (2) the extent of irreparable harm to plaintiff, (3) the harm to defendants if the injunction is granted and (4) the public interest.

 

[23] **Bankruptcy** ⇦ Purpose

Congress has established a system under the Bankruptcy Code that favors the ability of companies to restructure rather than liquidate.

**Attorneys and Law Firms**

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John J. Siemietkowski, Andrew Warner, United States Department of Justice, Washington, DC, for Defendant.

**MEMORANDUM OPINION**

JOHN T. DORSEY, U.S.B.J.

Debtor, True Health Diagnostics, LLC ("True Health") filed this adversary proceeding and Motion for a Preliminary Injunction (the "Motion") against Defendants, Alex M. Azar II (the "Secretary") and Seema Verma ("CMS") (D.I. 3) seeking to enforce the automatic stay pursuant to 11 U.S.C. § 362 to prevent the Defendants from withholding Medicare payments to True Health post-petition. For the reasons set forth below, the Court will enforce the automatic stay and order the Defendants to release all Medicare payments withheld post-petition, and continue to make payments until the earlier of: (a) the Court's entry of a final judgment in this adversary proceeding; or (b) the Court's entry of an order terminating the relief granted by this Order Enforcing the Automatic Stay.

**I. BACKGROUND**

True Health is a laboratory provider of diagnostic and disease management solutions. Many of the tests that True Health provides are paid for by the Medicare Program established under 42 U.S.C. Ch. 7, Subch. XVIII. Medicare is a federally funded program that provides payment for the provision of healthcare to millions of aged or disabled individuals, including the diagnostic laboratory services that True Health provides. Federal regulations permit CMS to suspend, offset, and recoup *158 Medicare payments to providers for various reasons, including where "a credible allegation of fraud exists against a provider or supplier, unless there is good cause not to suspend payments."42 C.F.R. § 405.371(a)(2).

On May 30, 2017, True Health received a notice of suspension of Medicare payments informing it that CMS had suspended 100% of Medicare payments based on alleged credible allegations of fraud, later reduced to 35%. On June 13, 2019, True Health received a second suspension notice imposing yet another 100% suspension of Medicare payments, once again based on alleged credible allegations of fraud.

On July 2, 2019, True Health filed an action seeking a temporary restraining order and a preliminary injunction in the District Court for the Eastern District of Texas against the Secretary and CMS (the "Texas Action"). Shortly after the initiation of the Texas Action, CMS issued two overpayment determinations to True Health: one for $19,759,699.00 for the period October 1, 2015 through January 1, 2017 and the second for $7,707,443.32 for the period May 25, 2017 through October 5, 2017. Defendants' Opp. at 3; D.I. 13. The Texas court issued a temporary restraining order but later denied True Health's request for a preliminary injunction and dismissed the action, concluding that it lacked subject matter jurisdiction.[1]

On July 30, 2019, True Health filed for chapter 11 bankruptcy protection, initiated the Adversary Proceeding and filed this Motion seeking to enforce the automatic stay. The Defendants oppose the motion on several grounds, including that: (i) the Court lacks subject matter jurisdiction to enforce the automatic stay; (ii) even if jurisdiction exists, withholding Medicare payments is an exercise of CMS's police or regulatory power; (iii) the Medicare payments are not property of the Debtor's estate; (iv) True Health has not shown it will suffer irreparable harm; (v) the Defendants' interest in protecting the Medicare system outweighs any harm to True Health; and (vi) enforcing the automatic stay would not serve the public interest. The Court rejects each of the Defendants' arguments.

**II. JURISDICTION**

The Defendants contend that the Court lacks subject matter jurisdiction because True Health's claims arise under the Medicare Act, and sections 405(h) and 1395ii of Title 42 bar the Court from entertaining the motion until True Health exhausts its administrative remedies.[2] The Court disagrees

*159 and finds that it has jurisdiction under 28 U.S.C. §§ 157 and 1334.

[1] The Third Circuit addressed this very issue extensively in *University Medical Center*, where it stated, in agreement with the Ninth Circuit, that "where there is an independent basis for bankruptcy court jurisdiction, exhaustion of administrative remedies pursuant to other jurisdictional statutes is not required". *University Medical Center v. Sullivan*, 973 F.2d 1065, 1073-74 (3rd Cir. 1992). The defendant in *University Medical Center* argued that the court lacked jurisdiction because the administrative review procedures had not been exhausted. The Third Circuit determined that the exercise of jurisdiction turned on whether the claims arose under the Medicare Act. Concluding that the issue of withholding Medicare reimbursement payments was only before it because the debtor filed for bankruptcy and claimed that the withholding violated the automatic stay, the Court found that the claim arose under the Bankruptcy Code and not the Medicare Act.

In coming to its conclusion, the Third Circuit considered whether exercising jurisdiction would encroach upon the Secretary's authority under section 405(h):

> we recognize that a broad reading of section 405(h) might accord with Congress' intent to allow "the Secretary in Medicare disputes to develop the record and base decisions upon his unique expertise in the health care field. The misfortune that a provider is in bankruptcy when he has a reimbursement dispute with the Secretary should not upset the careful balance between administrative and judicial review." *In re St. Mary Hosp.*, 123 B.R. 14, 17 (E.D.Pa.1991). However, a finding that jurisdiction is proper in this case does not impinge upon this authority of the Secretary protected by section 405(h). Indeed, there is no danger of rendering the administrative review channel superfluous, for there is no system of administrative review in place to address the issues raised by UMC in its adversary proceeding.

*Id.* at 1073.

Here, just as in *University Medical Center*, the Defendants challenge the Court's ability to exercise jurisdiction, arguing that section 405(h) bars bankruptcy courts from exercising jurisdiction over Medicare claims and that such claims must be channeled through the administrative process. Defendants attempt to distinguish *University Medical Center* by arguing that the parties in that case had stipulated to the amount of the overpayment and that any substantive dispute concerning the amounts due would be handled through the administrative process. There is no similar stipulation here. Defendants' argument misses the mark. While there is no stipulation in place in this case, the Court will not be addressing whether CMS's imposition of the 2019 fraud suspension and overpayment determinations were appropriate. If the issue was the appropriateness of the overpayment determinations, the Court would agree with the Defendants that that determination should be channeled through the administrative process. However, the issue before the Court is the narrow question of whether the Defendants are in violation of the automatic stay by continuing to withhold Medicare payments post-petition for medical tests performed by True Health post-petition based upon alleged pre-petition overpayments. Because the only issue is whether the withholding of post-petition reimbursements is a violation of the automatic stay, it is not, as the Defendants argue, inextricably *160 intertwined with pre-petition fiscal reimbursement determinations. As True Health correctly points out, those issues will be addressed through the administrative process, and that process will determine the amount, if any, of Defendants' pre-petition unsecured claim.

At oral argument, Defendants asserted that there are additional post-petition fraud and overpayment allegations that were being investigated. The Defendants failed to provide any admissible evidence to support those assertions, and, therefore, the Court gives them no weight.[3]

## III. DISCUSSION

### a. The Automatic Stay

The Court views this Adversary Proceeding and Motion as an action to enforce the automatic stay under section 362 of the Bankruptcy Code. Indeed, at oral argument, True Health's counsel stated as much on the record. Given that any ruling on the Motion turns on whether the automatic stay applies, the Court will start its analysis there.

[2] [3] [4] [5] [6] [7] The automatic stay is one of the most fundamental protections provided by the Bankruptcy Code, giving the debtor a breathing spell from its creditors. *Cuffee v. Atlantic Bus. & Cmty. Dev. Corp.*, 901 F.2d 325, 327 (3rd Cir. 1990). The scope of the automatic stay is very broad. Section 362 states that "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate" and "any act

to collect, assess, or recover a claim against the debtor that arose before the commencement of the case" is subject to the automatic stay. 11 U.S.C. § 362(a). Property of the estate is defined in section 541 as "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). It is well settled law in the Third Circuit that section 541(a)(1) was intended to sweep broadly to include all property whether tangible, intangible, contingent, or postponed, because "the mere opportunity to receive an economic benefit in the future is property with value under the Bankruptcy Code." *The Majestic Star Casino, LLC v. Barden Dev., Inc.*, 716 F.3d 736, 750-51 (3rd Cir. 2013). Clearly, the stay is designed to halt all collection efforts in order to allow the debtor time to reorganize.

**[8]** Congress intended the automatic stay to apply to the government when acting as a creditor. Indeed, by its terms, section 362(a) applies to all "entities". Entity is defined under the Bankruptcy Code as including governmental units. 11 U.S.C. 101(15); *See also Penn Terra Ltd. v. Dept, of Envtl. Resources*, 733 F.2d 267, 272 (3rd Cir. 1984) ("the fact that Congress created an exception to the automatic stay for certain actions by governmental units itself implies that such units are otherwise affected by the stay.").

**[9]** The post-petition Medicare reimbursements are indisputably property of the estate. True Health has received the reimbursements throughout the ordinary course of its business in exchange for its services as a healthcare provider. While these payments are being escrowed pending overpayment determinations, they are merely postponed payments that True Health expects to receive. Therefore, those payments fall squarely within the scope of property of the estate under section 541. ***161** In its opposition, Defendants cite two cases out of the Fifth Circuit which hold that health care providers do not have a property interest in Medicare reimbursements. However, those holdings are unpersuasive as they do not address whether Medicare payments are property of a bankruptcy estate under section 541. *Shah v. Azar*, 920 F.3d 987, 998 (5th Cir. 2019) (health care providers are not the intended beneficiaries of the federal health programs and therefore have no property interest in reimbursements); *Personal Care Prod. Inc. v. Hawkins*, 635 F.3d 155, 159 (5th Cir. 2011) ("[n]othing in Texas or federal law extends a property right in Medicaid reimbursements to a provider that is the subject of a fraud investigation."). Having determined that the Medicare reimbursement payments are property of the estate, the question becomes whether the automatic stay applies.

**[10]** **[11]** The police power exception is the only governmental exception to the automatic stay created by Congress, which provides that the stay does not apply to actions "to enforce such governmental unit's police and regulatory power". 11 U.S.C. 362(b)(4). This exception was intended to discourage debtors from using the bankruptcy process to evade governmental efforts to invoke its "police powers to enjoin or deter ongoing debtor conduct which would seriously threaten the public safety and welfare". *In re Nortel Networks, Inc.*, 669 F.3d 128, 137 (3rd Cir. 2011).

**[12]** **[13]** **[14]** **[15]** **[16]** **[17]** To determine whether a governmental unit's actions fall within the police power exception, courts apply two overlapping tests: the pecuniary interest and public policy tests. The pecuniary interest test asks whether the government "primarily seeks to protect a pecuniary governmental interest in the debtor's property," whereas the public policy test asks whether the government is enforcing public policy as opposed to private rights. *Id.* at 139-40.

> If the purpose of the law is to promote public safety and welfare or to effectuate public policy, then the exception to the automatic stay applies. If, on the other hand, the purpose of the law is to protect the government's pecuniary interest in the debtor's property or primarily to adjudicate private rights, then the exception is inapplicable.

Id. at 140. The purpose of these tests is to get to the heart of the reasoning behind the government's actions to avoid relying on unsupported statements of intent.

**[18]** Nothing in the record suggests that the Defendants' withholding of the post-petition Medicare payments is for any purpose other than protecting its pecuniary interest in property of the estate over the interests of other unsecured creditors. Moreover, nothing in the record supports a finding that the Defendants' actions are an effort to enforce public policy. Further, as discussed above, the Defendants have not put forth any evidence that True Health engaged in fraud post-petition or that there have been any overpayments post-petition. Indeed, the Defendants in their own pleadings stated that all the alleged fraud and overpayments occurred before the petition date. Opp. at 3. The only reasonable conclusion is that the Defendants are withholding post-petition payments on account of pre-petition overpayment determinations—the exact conduct that the pecuniary interest test was designed to prohibit. Therefore, the Court finds that the Defendants' withholding of post-petition reimbursement payments is a

violation of the automatic stay as it does not fall within the police power exception.

b. Preliminary Injunction

[19] Having concluded that the post-petition Medicare reimbursement payments *162 are property of the estate and that the Defendants have violated the automatic stay, the analysis turns to whether or not the Court should enjoin the withholding of post-petition Medicare reimbursement payments. Defendants argue that the Court cannot issue an injunction because True Health fails to meet the four-part test for issuing a preliminary injunction. The automatic stay, however, "is self-executing, effective upon the filing of the bankruptcy petition". *Gruntz v. County of Los Angeles*, 202 F.3d 1074, 1081-82 (9th Cir. 2000). Therefore, the Court finds it is not necessary for True Health to establish each of the factors necessary to impose a preliminary injunction because the Bankruptcy Code itself establishes the basis for enforcement of the automatic stay.

[20] [21] Specifically, by showing that the post-petition Medicare payments are property of True Health's estate, and that none of the exceptions under section 362 of the Code apply, including the police powers exception, True Health has shown that it is entitled to relief, thus establishing a likelihood of success. There is no need for True Health to show irreparable harm because Section 362 does not require a showing of irreparable harm for the automatic stay to apply. *In re Minoco Group of Co., Ltd.*, 799 F.2d 517, 520 (9th Cir. 1986) ("The automatic stay comes into play upon the filing of a bankruptcy petition whether or not the debtor would suffer irreparable harm in the absence of the stay."). Similarly, Section 362 does not impose a requirement that the balance of the equities favors the debtor, nor that imposition of the automatic stay is in the public interest. Indeed, requiring such a showing would read into Section 362 requirements for application of the automatic stay that Congress did not provide for in the Code. Thus, the Court finds that True Health has established the necessary requirements for application of the automatic stay.

[22] Even if it was necessary to establish the preliminary injunction factors for the automatic stay to apply, True Health met those requirements. The Court must consider the following factors in deciding whether to grant a preliminary injunction: (1) likelihood that the plaintiff will prevail on the merits, (2) the extent of irreparable harm to True Health, (3) the harm to the Defendants if the injunction is granted and (4) the public interest. *Reilly v. City of Harrisburg*, 858 F.3d 173, 177 (3rd Cir. 2017).

True Health has met each of the requisite factors. The likelihood of success on the merits is evident as the Court has already found that the Defendants violated the automatic stay. Also, True Health has shown that it will suffer irreparable harm if the injunction is not issued. Not only is True Health deprived of a significant portion of its revenues as a result of the withholding of payments post-petition, but without those payments True Health will be in default of its DIP financing. The result would be a loss of the ability to reorganize. The Defendants argue that True Health cannot point to a "self-inflicted" wound as irreparable harm, referencing the possibility of a default on the DIP financing if the injunction is not granted. It was the DIP lender, however, that insisted on that term, not True Health. Indeed, exclusion of that provision would inure to True Health's benefit.

The Defendants, on the other hand, have not shown that they would suffer any harm if the injunction is granted. The Defendants argue that they have a strong interest in protecting the Medicare system from financial loss and fraud. The only evidence before the Court, however, is that the Defendants are withholding payment for the purpose of recovering overpayments *163 made to True Health pre-petition. Those overpayments constitute pre-petition unsecured claims. The Bankruptcy Code provides a method for the Defendants to make a claim, along with other pre-petition unsecured creditors, to recover on those pre-petition claims. The balance of the equities, therefore, lies with True Health and its estate.

[23] Finally, the Defendants argue that allowing True Health to liquidate would not have any impact on the public interest. The Court disagrees. Congress has established a system under the Bankruptcy Code that favors the ability of companies to restructure rather than liquidate. *In re Kaiser Aluminum Corp.*, 456 F.3d 328, 343 (3rd Cir. 2006) ("An approach that results in unnecessary liquidations is neither fair nor consistent with the Bankruptcy Code's preference for reorganization."); *In re Baker & Drake, Inc.*, 35 F.3d 1348, 1354 (9th Cir. 1994) (Congress' purpose in enacting the Bankruptcy Code was to "establish a preference for reorganizations"). Certainly, the creditors of True Health will benefit from the ability of the company to market and sell itself as a going concern rather than being sold in a fire sale liquidation. In addition, several hundred employees may be able to keep their jobs in a going concern sale that would

 

not occur in a liquidation. The Court also disagrees with the Defendants' argument that liquidation would have no impact on patient care. There are perhaps thousands of patient samples that are either on their way to or are waiting testing by True Health's labs. Not just Medicare patients, but private pay patients as well. If forced to stop testing and liquidate, those patients would have to resubmit samples to other labs, thus delaying their results. That delay, even if only a few days, could potentially have serious implications for some patients. Therefore, continuing to operate as a going concern, providing healthcare services, serves the public's interest.

## IV. CONCLUSION

For the foregoing reasons, the Court will grant True Health's Motion to enforce the automatic stay preventing the Defendants from withholding post-petition Medicare reimbursement payments to True Health. The Court will enter an order giving effect to this ruling.

**All Citations**

604 B.R. 154

Footnotes

1 After the Texas court entered the temporary restraining order, Defendants provided True Health with notice that its review was complete and provided the estimated overpayment amounts. True Health's due process argument became moot as a result of the overpayment determinations. The Texas court then determined that it lacked subject matter jurisdiction because the remaining issues arose under the Medicare Act. *True Health Diagnostics, LLC v. Azar*, No. 9:19-CV-00110-MJT, 392 F.Supp.3d 666, 2019 WL 3308203 (E.D. Tex. Jul. 22, 2019).

2 Through its ongoing claim payment and review processes, Defendant, CMS, may determine that it has overpaid a provider. An "overpayment" constitutes "any funds" that a person receives or retains under the Medicare program "to which the person, after applicable reconciliation, is not entitled." 42 U.S.C. § 1320a-7k(d)(4). Further, Medicare suppliers are subject to post-payment audits of their claims and are entitled to four levels of administrative appeals, and a final level of judicial review pursuant to 42 U.S.C. § 1395ff and 42 C.F.R. § 405.900 et seq. Defendants are precluded from recouping overpayments until a supplier has completed and received a decision on the second level of administrative review. 42 C.F.R. §§ 405.940, 405.942, 405.950. Only after this second level of review is completed may HHS's Secretary recoup the overpayment. 42 C.F.R. §§ 405.960, 405.962, 405.970.

3 Defendants attempted to introduce two declarations filed in the Texas Action after representing to the Court during a teleconference prior to the hearing that no evidence would be submitted. The Court denied the admission of the declarations based upon that representation and because the declarations were clearly hearsay.

End of Document

AMERICAN BANKRUPTCY INSTITUTE 2021 ANNUAL SPRING MEETING

# MAINTENANCE & DISPOSAL OF RECORDS

**IN THE UNITED STATES BANKRUPTCY COURT**
**FOR THE SOUTHERN DISTRICT OF INDIANA**
**NEW ALBANY DIVISION**

| | |
|---|---|
| In re: | Chapter 7 |
| KENTUCKIANA MEDICAL CENTER, LLC, | Case No. 19-90617-AKM-7 |
| Debtor. | |

**TRUSTEE'S MOTION FOR AUTHORITY TO ENTER INTO AN AGREEMENT WITH METALQUEST, INC. FOR THE STORAGE AND DISPOSAL OF PATIENT MEDICAL RECORDS AND OTHER BUSINESS RECORDS AND TO PAY METALQUEST, INC. FOR ITS SERVICES**

Kathryn L. Pry, the chapter 7 trustee in this case (the "Trustee"), by counsel, requests entry of an order, pursuant to 11 U.S.C. §§ 105, 363, 351 and 503, authorizing the Trustee to enter into an agreement with MetalQuest, Inc. ("MetalQuest") for the storage and disposal of patient medical records and other business records and authorizing payment to MetalQuest for its services, on the following grounds:

## I. JURISDICTION

1. The Court has jurisdiction over this motion pursuant to 28 U.S.C. §§ 157 and 1334. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2).

2. Venue is proper in this district pursuant to 28 U.S.C. §§ 1408 and 1409.

3. The statutory predicates for relief are sections 105, 363, 351 and 503 of Title 11 of the United States Code (the "Bankruptcy Code") and Rule 6011 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules").

## II. BACKGROUND

4. On April 23, 2019, Jeffrey A. Campbell MD, Physicians Primary Care, LLC, Eli Hallal MD and Renato LaRocca MD (together, the "Petitioning Creditors") filed an involuntary

petition under chapter 7 of the Bankruptcy Code against Kentuckiana Medical Center, LLC (the "Debtor").

5. On May 9, 2019, pursuant to the *Order Granting Emergency Motion of Petitioning Creditors Under 11 U.S.C. §§ 105(a) and 303(g) for Order Directing Appointment of Interim Trustee* [Doc 17] and the *Appointment of Trustee* [Doc 18], the Trustee was appointed as the interim trustee in this case, pursuant to section 303(g) of the Bankruptcy Code, over the Debtor's accounts receivables and causes of action.

6. On May 23, 2019, pursuant to the *Order for Relief in an Involuntary Case and Order to Complete Filing* (the "Order for Relief") [Doc 29] and with the consent of the Debtor, the Court granted the Petitioning Creditors' request for an order for relief under chapter 7 of the Bankruptcy Code and the Trustee was appointed the interim trustee in this case over all assets of the Debtor's bankruptcy estate pursuant to section 701(a)(1) of the Bankruptcy Code. In accordance with section 702(d) of the Bankruptcy Code, the Trustee became the permanent case trustee on July 29, 2019 following the conclusion of the meeting of creditors held pursuant to section 341(a) of the Bankruptcy Code.

7. Prior to the filing of the involuntary bankruptcy petition, the Debtor and its affiliate, KMC Real Estate Investors, LLC ("KMCREI") developed, owned and operated a small hospital in Clarksville, Indiana. KMCREI owned real estate commonly known as 4601 Medical Plaza Way, Clarksville, Indiana 47129, which was the location of the hospital operated by the Debtor (the "Hospital"). The Hospital was a financial failure, forcing the Debtor and KMCREI to file chapter 11 cases in 2010 and 2011, respectively. The chapter 11 plans of reorganization were confirmed in 2013, pursuant to which RL BB-IN KRE, LLC (the "Lender") and its affiliate, RL BB Financial, LLC, provided the necessary exist financing for the Debtor and KMCREI.

Unfortunately, the Hospital was still unable to achieve profitability, leading to a foreclosure action against KMCREI and this chapter 7 case against the Debtor.

8. Prior to the filing of the involuntary bankruptcy petition, substantially all of the Debtor's assets were acquired by the Lender (the Debtor's primary secured creditor) in an Article 9 sale conducted on April 5, 2019.[1] Accordingly, as of the involuntary filing date, the only assets of the bankruptcy estate were causes of action.

9. Following the filing, it was determined that the Debtor's patient records should be disposed of in accordance with section 351 of the Bankruptcy Code. It order to pay the costs associated with the Trustee's compliance with section 351 of the Bankruptcy Code and the Trustee's reasonable and necessary professional fees, the Trustee and the Lender entered into an agreement for secured postpetition financing. The postpetition financing agreement between the Lender and the Trustee was approved on March 25, 2020 pursuant to the *Order Granting Trustee's Motion for Final Order Authorizing Trustee to Obtain secured Postpetition Financing and Granting Superpriority Claims to Postpetition Lender* (the "Financing Order") [Doc 131].

**MetalQuest Agreement**

10. Prior to the involuntary filing, the Debtor maintained certain health information, electronic protected health information and business records (the "Records"). The Records exist in various forms, including paper, films, and electronic data files and are subject to various non-bankruptcy federal and state law requirements relating to the storage, access and eventual destruction of any records that no longer need to be preserved.

[1] The Trustee is still conducting due diligence on the Lender's secured claim and the Article 9 sale. Accordingly, the Trustee reserves all rights to contest the validity of the Article 9 sale and any and all other claims against the Lender, if any, that have not otherwise been released.

11. The vast majority of the Records are maintained in electronic format with Cerner Corporation (medical records) and NovaRad (radiology records). Upon information and belief, there are hardcopy Records that are presently stored with File Management Pros., LLC. In addition, the Trustee believes that the Debtor's servers located at the Hospital and with Flexential contain Records as well.

12. Following the entry of the Financing Order, the Trustee negotiated the *Lifecycle Management of Clinical and Non-Clinical Information Trust Agreement* (the "Agreement") with MetalQuest. The Agreement is attached as **Exhibit 1** and incorporated herein.

13. The Agreement provides for an orderly process for the transfer and transition of the Records to MetalQuest who will permanently store, maintain, provide access to, transmit, catalog, index and periodically destroy the Records, all in accordance with Applicable Law,[2] including section 351 of the Bankruptcy Code. As set forth in the Agreement, MetalQuest has agreed to assume the custody and storage of the Records in accordance with Applicable Law and will exercise administrative, physical and technical safeguards in order to assure confidentiality, integrity and availability of the Records.

**MetalQuest Services and Fees**

14. As further described in the Agreement, MetalQuest is to provide the following services:

(a) Accepting and fulfilling valid release of information requests to patients, doctors and third-parties representing patients, including maintaining a website that provides detailed instructions regarding retrieval of Records;

[2] "Applicable Law" refers to the *Health Insurance Portability and Accountability Act of 1996* ("HIPAA"), the *HIPAA Privacy and Health Insurance Portability and Accountability Act of 1996* ("HIPAA Privacy and Security Rules"), other applicable Federal law (including section 351 of the Bankruptcy Code), and Indiana State law (including the Indiana Record Retention Requirements).

(b) Management and maintenance of Records in accordance with Applicable Law, including the removal/extraction of the Records and integration of the Records into MetalQuest's storage environment;

(c) Notification to patients, including placing a legal ad in the local newspapers and by website and by US mail to former patients, provided however, there is an additional cost of $1.15 per patient for U.S. mail notification;

(d) All freight charges, with the exception of pallets, boxes, stretch-wrap and miscellaneous packaging supplies required to ship the Records from File Management Pros., LLC to MetalQuest's facility; and

(e) The eventual disposal of all Records in accordance with Applicable Law, including section 351 of the Bankruptcy Code.

15. MetalQuest fees for such services include the following:

(a) A flat fee of $100,000.00 for the management of electronic data extracted from the Cerner electronic medical record, including data storage, retrieval, indexing, secure destruction and freight;

(b) A flat fee of $25,000.00 for the management of electronic data extracted from the NovaRad PACS, including data storage, retrieval, indexing, secure destruction and freight;

(c) To the extent the Trustee determines that MetalQuest's services are needed, a flat fee of $75,000.00 for the hosting and management of IT equipment and software received from Flexential and/or the servers located at the Hospital, including data storage, retrieval, indexing, secure destruction and freight; and

(d) To the extent the Trustee determines that MetalQuest's services are needed, a flat fee of $25,000.00 for the management of hardcopy records received from File Management Pros., LLC, including record storage, retrieval, indexing, secure destruction and freight,

(collectively, the "Flat Fees"). The Flat Fees for the management of electronic data extracted from the Cerner electronic medical record and NovaRad PACS totaling $125,000.00 shall be paid in installments with an initial payment of $100,000.00, with the remaining balance of $25,000.00 to be paid within 180 days after the date of the initial payment. The remaining Flat Fees, to the extent the Trustee determines that MetalQuest's services are needed for a particular

matter, shall be paid in installments with an initial payment of 50% of the applicable Flat Fee, with the remaining balance to be paid within 180 days after the date of the initial payment; provided however, only if all other administrative expenses of the Debtor's bankruptcy estate have been reasonably determined by the Trustee and the Trustee, in her sole discretion, determines that there are sufficient funds available to pay the remaining balance and all other administrative expenses.

16. In addition, MetalQuest is to provide the following consulting services as requested by the Trustee:

(a) Consulting and plan preparation for the extraction and migration of data from Cerner financial, human resource and electronic medical records system to useful format not requiring Cerner software to access data;

(b) Consulting and plan preparation for the extraction and migration of data from the NovaRad PACS to a useful format not requiring NovaRad software to access data;

(c) Consulting and plan preparation for the storage, retrieval, request for record fulfillment and destruction of extracted and migrated data from Cerner, NovaRad PACS and Flexential hosted systems;

(d) Consulting and plan preparation for the storage, retrieval, request for record fulfillment and destruction of any other records retained by the Debtor not part of the Cerner, NovaRad PACS and Flexential hosted systems including pathology specimens; and

(e) Any other necessary information and services on a task by task basis,

(collectively, the "Consulting Services").

17. For Consulting Services, MetalQuest will be compensated on an hourly basis as follows:

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|---|---|
| William L. Jansen | $500.00/hour |
| Associates | $350.00/hour |
| Support Staff | $100/hour |

However, the hourly fees for Consulting Services shall not exceed a total of $20,000.00.

18. MetalQuest shall also be entitled to reimbursement of reasonable expenses, including travel costs, courier and postage fees, photocopying, scanning, and other out-of-pocket expenses in connection with the Consulting Services. The Agreement provides that the Trustee shall pay MetalQuest's fees and expense reimbursement in connection with the Consulting Services upon receipt of detailed time records provided by MetalQuest.

## III. RELIEF REQUESTED

19. The Trustee requests entry of an order, substantially in the form attached as **Exhibit 2**, (a) authorizing the Trustee to enter into the Agreement with MetalQuest for the storage and disposal of the Records and to pay MetalQuest, without further Court order, its fees and expenses for services based upon the terms and conditions in the Agreement as an administrative expense of the bankruptcy estate, (b) directing that payment of MetalQuest's fees and expenses shall be from the proceeds of the postpetition financing pursuant to the terms of the Financing Order or from funds held by the bankruptcy estate to the extent the postpetition financing is insufficient to cover all costs associated with the Records, and (c) authorizing MetalQuest, on behalf of the Trustee, to store and dispose of the Records in accordance with all Applicable Laws, including section 351 of the Bankruptcy Code.

## IV. GROUNDS FOR GRANTING RELIEF

20. The Trustee submits in the reasonable exercise of her sound business judgment that the Agreement with MetalQuest is in the best interests of the Debtor's bankruptcy estate and its creditors. The retention and final disposition of the Records is a complex process, involving contemplation of numerous considerations such as the type and format of the Record, applicable retention period for each such Record, the current location and continued access of the Records, and the costs associated with the retention and eventual destruction of the Records. In addition,

the Trustee must comply with various Applicable Laws and other regulations which govern the retention and destruction of the Records. The proposed Agreement with MetalQuest permits the Trustee to uphold her obligations under the Applicable Laws, including section 351 of the Bankruptcy Code, as it relates to the Records.

21. Section 363(b)(1) of the Bankruptcy Code governs transactions outside of the ordinary course of business and provides, in relevant part, that "[t]he trustee, after notice and hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . ." 11 U.S.C. § 363(b)(1). Pursuant to section 105(a) of the Bankruptcy Code, the "court may issue any order, process, or judgment that is necessary to carry out the provisions of this title." 11 U.S.C. § 105(a).

22. Although section 363 of the Bankruptcy Code does not set forth a standard for determining when it is appropriate for a court to authorize the disposition of a debtor's assets, approval for the use of property of the bankruptcy estate outside the ordinary course of business should be approved if the Trustee can demonstrate a sound business justification for the proposed transaction. *See In re Ionosphere Clubs, Inc.*, 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989) (noting the standard for determining a section 363(b) motion is a "good business reason").

23. A sound business justification exists for the Trustee to enter into the Agreement with MetalQuest. The protection, transfer and storage of the Records are important and is required by Applicable Laws. Now that the postpetition financing is in place, it is essential that the Trustee engage MetalQuest as soon as possible so it can obtain access to the Records and properly sort, index and store the Records to ensure that patients, regulatory agencies and physicians, as appropriate, have access to the Records. By entering into the Agreement, the

Trustee will be abiding by all Applicable Laws while providing former patients with efficient access to the Records.

24. MetalQuest is experience in record retention and disposal and has provided similar services to other healthcare entities, including those in bankruptcy, such as the following: (a) Record Trustee for the Saint Vincent Catholic Medical Center, New York, Chapter 11; (b) Record Trustee for the San Diego Hospice, California, Chapter 7; (c) Record Trustee for the Sound Shore Health System, New York, Chapter 11; (d) Record Trustee for the Caritas Health Care, New York, Chapter 11; and (e) Record Trustee for the Fayette memorial Hospital Association, Inc. d/b/a Fayette Regional Health Systems, Indiana, Chapter 11.

25. The Trustee submits that MetalQuest's fees, as provided in the Agreement, are both reasonable and necessary. Moreover, pursuant to the Financing Order, such fees were contemplated in the Agreed Budget for the use of the proceeds from the postpetition financing. [Financing Order at ¶ 11.]

26. As evidenced by the need for the postpetition financing, the bankruptcy estate does not have sufficient funds to pay for the ongoing storage of the Records in the manner required under Applicable Laws. Accordingly, the alternative procedure set forth in section 351 of the Bankruptcy Code applies to the ultimate disposal of the Records in this case. The Agreement provides that MetalQuest will act as trustee for the Records in compliance with section 351 of the Bankruptcy Code in satisfaction of the Trustee's obligations under section 351 of the Bankruptcy Code as it pertains to the Records.

27. Specifically, as required by section 351(1)(A) of the Bankruptcy Code, the Agreement provides that MetalQuest will provide the required notification to the Debtor's former patients by placing a legal ad in local newspapers and by its website. [Agreement Ex. A

at § E.3.] This notice will provide that if Records are not claimed by the patient by the date that is 365 days after the date of that notification, MetalQuest, on behalf of the Trustee, will destroy the Records. Such notice will comply with the requirements of Bankruptcy Rule 6011(a) and will not identify any patient by name or other identifying information, but will include the following: (a) the Debtor's name; (b) information for how to obtain the Records, including MetalQuest's address, telephone number, email address, and website; and (c) will state the date by which the Records must be claimed, and that if they are not so claimed the Records will be destroyed.

28. In addition, as required by section 351(1)(B), to the extent the Trustee is able to access a useable mailing list of the Debtor's former patients, the Trustee will request MetalQuest provide notification by U.S. mail directly to the Debtor's former patients within the first 180 days of the 365-day period regarding the claiming or disposing of the Records. [Agreement Ex. A at § E.5.] Such notice will comply with the requirements of Bankruptcy Rule 6011(b) and will include in addition to the information required under Bankruptcy Rule 6011(a), instructions that a patient's family member or other representative who receives the notice to inform the patient of the notice. This notice will also be provided to the Attorney General of the State of Indiana. MetalQuest will maintain proof of compliance with section 351(1)(B) of the Bankruptcy Code. *See* Bankruptcy Rule 6011(c).

29. Following the expiration of the 365-day period described in section 351(1) of the Bankruptcy Code, the Trustee and/or MetalQuest will mail, by certified mail, a written request to each appropriate Federal agency to request permission from that agency to deposit the Records with that agency. *See* 11 U.S.C. § 351(2). To the extent the Records are not claimed by a patient or request is not granted by a Federal agency to deposit such records with that agency,

MetalQuest will destroy those Records in accordance with section 351(3) of the Bankruptcy Code. No later than 30 days after the destruction of the Records, the Trustee will file a report certifying that the unclaimed Records have been destroyed and explaining the method used to effect the destruction. *See* Bankruptcy Rule 6011(d).

## V. NOTICE

30. A copy of this motion, along with the attached exhibits, will be served on the following: (a) the United States Trustee; (b) the Debtor's counsel; (c) the Lender's counsel; and (d) those parties who have requested notice pursuant to Bankruptcy Rule 2002.

31. The Trustee is contemporaneously filing a "9006(c) Request" requesting the Court to shorten notice on this motion to seven (7) days in order for the Trustee to enter into the Agreement as soon as possible in order to provide for a speedy resolution of the issues regarding the Records.

**WHEREFORE**, the Trustee respectfully requests entry of an order, substantially in the form attached as **Exhibit 2**, (i) authorizing the Trustee to enter into the Agreement with MetalQuest for the storage and disposal of the Records and to pay MetalQuest, without further Court order, its fees and expenses for services based upon the terms and conditions in the Agreement as an administrative expense of the bankruptcy estate, (ii) directing that payment of MetalQuest's fees and expenses shall be from the proceeds of the postpetition financing pursuant to the terms of the Financing Order or from funds held by the bankruptcy estate to the extent the postpetition financing is insufficient to cover all costs associated with the Records, (iii) authorizing MetalQuest, on behalf of the Trustee, to store and dispose of the Records in accordance with all Applicable Laws, including section 351 of the Bankruptcy Code, and (iv) and granting the Trustee all other just and proper relief.

Respectfully submitted,

RUBIN & LEVIN, P.C.

Dated: May 8, 2020

*/s/ Meredith R. Theisen*
Meredith R. Theisen

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*Counsel for Kathryn L. Pry, Trustee*

**CERTIFICATE OF SERVICE**

I hereby certify that on May 8, 2020 a copy of the foregoing *Trustee's Motion for Authority to Enter into an Agreement with MetalQuest, Inc. for the Storage and Disposal of Patient Medical Records and Other Business Records and to Pay MetalQuest, Inc. for its Services* was filed electronically. Notice of this filing will be sent to the following parties through the Court's Electronic Case Filing System. Parties may access this filing through the Court's system.

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I further certify that on May 8, 2020, a copy of the foregoing *Trustee's Motion for Authority to Enter into an Agreement with MetalQuest, Inc. for the Storage and Disposal of Patient Medical Records and Other Business Records and to Pay MetalQuest, Inc. for its Services* was mailed by first-class U.S. Mail, postage prepaid and properly addressed to the following:

None.

*/s/ Meredith R. Theisen*
Meredith R. Theisen

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**IN THE UNITED STATES BANKRUPTCY COURT**
**FOR THE SOUTHERN DISTRICT OF INDIANA**
**NEW ALBANY DIVISION**

| | |
|---|---|
| In re:<br><br>KENTUCKIANA MEDICAL CENTER, LLC,<br><br>Debtor. | Chapter 7<br><br>Case No. 19-90617-AKM-7 |

**TRUSTEE'S MOTION FOR AUTHORITY TO ENTER INTO AN AGREEMENT WITH CERNER CORPORATION FOR ACCESS TO CERTAIN ELECTRONIC PATIENT AND FINANCIAL RECORDS**

Kathryn L. Pry, the chapter 7 trustee in this case (the "Trustee"), by counsel, requests entry of an order, pursuant to 11 U.S.C. §§ 105, 363 and 503, authorizing the Trustee to enter into an agreement with Cerner Corporation ("Cerner") for access to certain electronic patient and financial records and authorizing payment to Cerner pursuant to such agreement, on the following grounds:

## I. JURISDICTION

1. The Court has jurisdiction over this motion pursuant to 28 U.S.C. §§ 157 and 1334. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2).

2. Venue is proper in this district pursuant to 28 U.S.C. §§ 1408 and 1409.

3. The statutory predicates for relief are sections 105, 363, and 503 of Title 11 of the United States Code (the "Bankruptcy Code").

## II. BACKGROUND

4. On April 23, 2019, Jeffrey A. Campbell MD, Physicians Primary Care, LLC, Eli Hallal MD and Renato LaRocca MD (together, the "Petitioning Creditors") filed an involuntary petition under chapter 7 of the Bankruptcy Code against Kentuckiana Medical Center, LLC (the "Debtor").

5. On May 9, 2019, pursuant to the *Order Granting Emergency Motion of Petitioning Creditors Under 11 U.S.C. §§ 105(a) and 303(g) for Order Directing Appointment of Interim Trustee* [Doc 17] and the *Appointment of Trustee* [Doc 18], the Trustee was appointed as the interim trustee in this case, pursuant to section 303(g) of the Bankruptcy Code, over the Debtor's accounts receivables and causes of action.

6. On May 23, 2019, pursuant to the *Order for Relief in an Involuntary Case and Order to Complete Filing* (the "Order for Relief") [Doc 29] and with the consent of the Debtor, the Court granted the Petitioning Creditors' request for an order for relief under chapter 7 of the Bankruptcy Code and the Trustee was appointed the interim trustee in this case over all assets of the Debtor's bankruptcy estate pursuant to section 701(a)(1) of the Bankruptcy Code. In accordance with section 702(d) of the Bankruptcy Code, the Trustee became the permanent case trustee on July 29, 2019 following the conclusion of the meeting of creditors held pursuant to section 341(a) of the Bankruptcy Code.

7. Prior to the filing of the involuntary bankruptcy petition, the Debtor and its affiliate, KMC Real Estate Investors, LLC ("KMCREI") developed, owned and operated a small hospital in Clarksville, Indiana. KMCREI owned real estate commonly known as 4601 Medical Plaza Way, Clarksville, Indiana 47129, which was the location of the hospital operated by the Debtor (the "Hospital"). The Hospital was a financial failure, forcing the Debtor and KMCREI to file chapter 11 cases in 2010 and 2011, respectively. The chapter 11 plans of reorganization were confirmed in 2013, pursuant to which RL BB-IN KRE, LLC (the "Lender") and its affiliate, RL BB Financial, LLC, provided the necessary exist financing for the Debtor and KMCREI. Unfortunately, the Hospital was still unable to achieve profitability, leading to a foreclosure action against KMCREI and this chapter 7 case against the Debtor.

8. Prior to the filing of the involuntary bankruptcy petition, substantially all of the Debtor's assets were acquired by the Lender (the Debtor's primary secured creditor) in an Article 9 sale conducted on April 5, 2019.[1] Accordingly, as of the involuntary filing date, the only assets of the bankruptcy estate were causes of action.

9. Following the filing, it was determined that the Debtor's patient records should be disposed of in accordance with section 351 of the Bankruptcy Code or other applicable laws. It order to pay the costs associated with the Trustee's compliance with section 351 of the Bankruptcy Code and other applicable laws, and the Trustee's reasonable and necessary professional fees, the Trustee and the Lender entered into an agreement for secured postpetition financing. The postpetition financing agreement between the Lender and the Trustee was approved on March 25, 2020 pursuant to the *Order Granting Trustee's Motion for Final Order Authorizing Trustee to Obtain secured Postpetition Financing and Granting Superpriority Claims to Postpetition Lender* (the "Financing Order") [Doc 131].

**Cerner Agreements**

10. Prior to the Debtor ceasing operations on or about April 8, 2019, the Debtor and Cerner entered into a certain Cerner Business Agreement dated June 10, 2014 (the "Original Agreement"). The Original Agreement provides for the use and access to licensed software solution designed to, among other things, manage most, if not all of, the Debtor's patient, billing and financial records (the "Cerner Records") on systems provided by Cerner (the "Cerner Systems"). The Original Agreement also provides for information to be remotely hosted by

[1] The Trustee is still conducting due diligence on the Lender's secured claim and the Article 9 sale. Accordingly, the Trustee reserves all rights to contest the validity of the Article 9 sale and any and all other claims against the Lender, if any, that have not otherwise been released.

Cerner such that the information is stored with Cerner. To access the Cerner Records, a person needs both access to Cerner's servers and the Cerner Systems.

11. The Trustee and her agents have been unable to access the Cerner Records due to the Cerner Systems being discontinued for non-payment. On November 12, 2019, Cerner filed a proof of claim in this case (Proof of Claim No. 50), asserting a general unsecured claim in the amount of $782,201.78.

12. The Cerner Records remain with Cerner and are stored in a format that cannot be read without access to Cerner's servers and the Cerner Systems. The Trustee and her Court-approved agent, MetalQuest, Inc. ("MetalQuest"),[2] need access to the Cerner Records in order to investigate and pursue potential assets of the bankruptcy estate, collect any and all accounts receivables,[3] and to dispose of the Cerner Records in accordance with section 351 of the Bankruptcy Code and all other applicable laws.

13. The cost to cure the outstanding amounts owed to Cerner are prohibitive to assumption of the Original Agreement given that the funds available from the postpetition financing from the Lender are limited and need to be utilized to cover all costs associated with the disposal of all patient records in accordance with section 351 of the Bankruptcy Code and other applicable laws.

14. MetalQuest has confirmed that full access and use of the Cerner Systems is not required and that read only access is sufficient in order to fulfill its obligations under its

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[2] Pursuant to the *Order Granting Trustee's Motion for Authority to Enter into an Agreement with MetalQuest, Inc. for the Storage and Disposal of Patient Medical Records and Other Business Records and to Pay MetalQuest, Inc. for its Services* (the "MetalQuest Order") [Doc 143], MetalQuest is authorized, on behalf of the Trustee, to store and dispose of the Records in accordance with all applicable laws, including section 351 of the Bankruptcy Code.

[3] Pursuant to the terms of the postpetition financing agreement between the Trustee and the Lender, the financing is to be funded, in part, "from the Trustee's authorized collection of any and all accounts receivable relating to medical services provided by the Debtor prior to the Petition Date, including any and all accounts receivable previously collected by the Trustee." [Financing Order at ¶ 4.]

agreement with the Trustee for the storage and disposal of the Records in accordance with section 351 of the Bankruptcy Code and other applicable laws. As such, the Trustee has negotiated an agreement with Cerner for read only access to the Cerner Records (the "Trustee-Cerner Agreement"). The Trustee-Cerner Agreement is attached as **Exhibit 1** and incorporated herein.

**Terms of the Trustee-Cerner Agreement**

15. Pursuant to the Trustee-Cerner Agreement, MetalQuest, as an authorized user, will have read only access to the Cerner Records for a period of two (2) years for a total cost of $10,800.00 (the "Cerner Fee") that is to be paid within ten (10) days of the effective date of the Trustee-Cerner Agreement. Pursuant to the terms of the Trustee's agreement with MetalQuest, MetalQuest is to accept all electronic records requested by the Trustee. The Trustee has requested that MetalQuest accept all Cerner Records and that such acceptance be in the form of an authorized user, subject to all terms and conditions of the Trustee-Cerner Agreement.

16. Upon expiration of the Trustee-Cerner Agreement, the Original Agreement will also terminate, and pursuant to the terms of the Original Agreement, Cerner will destroy all the Cerner Records received from the Debtor, or created or received by Cerner on behalf of the Debtor and will retain no copies of the Cerner Records.

17. Pursuant to the Trustee-Cerner Agreement, the Trustee is not assuming the Original Agreement or any other prior sales orders with Cerner and the Trustee is only responsible for payment of the Cerner Fee in the amount of $10,800.00 and any distribution on account of any allowable general unsecured claim filed by Cerner in this case in the event the Trustee makes a distribution to general unsecured creditors.

18. The Cerner Fee represents a substantial discount compared to what Cerner typically charges for similar agreements. As partial consideration for this discount, the Trustee and Cerner have agreed to enter into mutual releases summaries as follows:

(a) The Trustee, as the legal representative of the Debtor's bankruptcy estate, is to release and forever discharge Cerner, and Cerner's affiliates, agents, attorneys, and representatives, from any claims and causes of actions arising prior to the Order for Relief, including (but not limited to) any cause of action arising under chapter 5 of the Bankruptcy Code; provided however, such release does not apply to any of Cerner's obligations under the Trustee-Cerner Agreement.

(b) Except for Cerner's proof of claim and any claim for obligations set forth in the Trustee-Cerner Agreement, Cerner, on behalf of itself and its representatives, is to release and forever discharge the Debtor, its bankruptcy estate, the Trustee, and the Trustee's agents, attorneys, and representatives, from any claims and causes of actions arising prior to the Order for Relief and any claim arising from the rejection of the Original Agreement and any related licenses.

In connection with the mutual releases, Cerner has expressly represented and warranted that it did not receive a transfer of property of the Debtor, including but not limited to any payment of funds from the Debtor, within 90-days prior to April 23, 2019, and the Trustee has agreed not to object to the allowance of Cerner's proof of claim.

## III. RELIEF REQUESTED

19. The Trustee requests entry of an order, substantially in the form attached as **Exhibit 2**, (a) authorizing the Trustee to enter into the Trustee-Cerner Agreement and to pay the Cerner Fee in the amount of $10,800.00 as an administrative expense of the bankruptcy estate, (b) directing that payment of the Cerner Fee shall be from the proceeds of the postpetition financing pursuant to the terms of the Financing Order, and (c) directing that MetalQuest's acceptance of the Cerner Records shall be in the form of an authorized user, subject to all terms and conditions of the Trustee-Cerner Agreement.

## IV. GROUNDS FOR GRANTING RELIEF

20. The Trustee submits in the reasonable exercise of her sound business judgment that the Trustee-Cerner Agreement is in the best interests of the Debtor's bankruptcy estate and its creditors. The Trustee-Cerner Agreement allows for MetalQuest to have the necessary access to the Cerner Records in order to fulfill the obligations, on behalf of the Trustee, to store and dispose of the Cerner Records in accordance with section 351 of the Bankruptcy Code and other applicable laws.

21. Section 363(b)(1) of the Bankruptcy Code governs transactions outside of the ordinary course of business and provides, in relevant part, that "[t]he trustee, after notice and hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . ." 11 U.S.C. § 363(b)(1). Pursuant to section 105(a) of the Bankruptcy Code, the "court may issue any order, process, or judgment that is necessary to carry out the provisions of this title." 11 U.S.C. § 105(a).

22. Although section 363 of the Bankruptcy Code does not set forth a standard for determining when it is appropriate for a court to authorize the disposition of a debtor's assets, approval for the use of property of the bankruptcy estate outside the ordinary course of business should be approved if the Trustee can demonstrate a sound business justification for the proposed transaction. *See In re Ionosphere Clubs, Inc.*, 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989) (noting the standard for determining a section 363(b) motion is a "good business reason").

23. A sound business justification exists for the Trustee to enter into the Trustee-Cerner Agreement. Absence such agreement, MetalQuest, on behalf of the Trustee, will not be able to fulfill its obligations to store and dispose of the Cerner Records in accordance with section 351 of the Bankruptcy Code and other applicable laws. In addition, access to the Cerner

Records is needed in order for the Trustee to investigate and pursue potential assets of the bankruptcy estate and collect any and all accounts receivables pursuant to the terms of the postpetition financing with the Lender.

24. The Trustee is not aware of any causes of action against Cerner and believes the release of all claims against Cerner, including any causes of action arising under chapter 5 of the Bankruptcy Code, is reasonable given the significant discount for access to the Cerner Records and Cerner's representation and warranty that it did not receive any transfer of property of the Debtor within 90-days prior to April 23, 2019.

## V. NOTICE

25. A copy of this motion, along with the attached exhibits, will be served on the following: (a) the United States Trustee; (b) the Debtor's counsel; (c) the Lender's counsel; (d) Cerner; (e) Cerner's counsel; (f) MetalQuest; (g) MetalQuest's counsel; and (h) those parties who have requested notice pursuant to Bankruptcy Rule 2002.

26. The Trustee is contemporaneously filing a "9006(c) Request" requesting the Court to shorten notice on this motion to seven (7) days in order for the Trustee to enter into the Trustee-Cerner Agreement as soon as possible in order to provide for a speedy resolution of the issues regarding the Cerner Records.

**WHEREFORE**, the Trustee respectfully requests entry of an order, substantially in the form attached as **Exhibit 2**, (i) authorizing the Trustee to enter into the Trustee-Cerner Agreement and to pay the Cerner Fee in the amount of $10,800.00 as an administrative expense of the bankruptcy estate, (ii) directing that payment of the Cerner Fee shall be from the proceeds of the postpetition financing pursuant to the terms of the Financing Order, (iii) directing that MetalQuest's acceptance of the Cerner Records shall be in the form of an authorized user,

subject to all terms and conditions of the Trustee-Cerner Agreement, and (iv) and granting the Trustee all other just and proper relief.

Respectfully submitted,

RUBIN & LEVIN, P.C.

Dated: June 23, 2020

*/s/ Meredith R. Theisen*
Meredith R. Theisen

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*Counsel for Kathryn L. Pry, Trustee*

**CERTIFICATE OF SERVICE**

I hereby certify that on June 23, 2020 a copy of the foregoing *Trustee's Motion for Authority to Enter Into an Agreement with Cerner Corporation for Access to Certain Electronic Patient and Financial Records* was filed electronically. Notice of this filing will be sent to the following parties through the Court's Electronic Case Filing System. Parties may access this filing through the Court's system.

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I further certify that on June 23, 2020, a copy of the foregoing *Trustee's Motion for Authority to Enter Into an Agreement with Cerner Corporation for Access to Certain Electronic Patient and Financial Records* was mailed by first-class U.S. Mail, postage prepaid and properly addressed to the following:

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*/s/ Meredith R. Theisen*
Meredith R. Theisen

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

| | | |
|---|---|---|
| IN RE: | ) | |
| | ) | |
| ITT EDUCATIONAL SERVICES, INC., *et al.*[1] | ) | Case No. 16-07207-JMC-7A |
| | ) | |
| Debtors. | ) | Jointly Administered |

**TRUSTEE'S BRIEF RESPONDING TO OBJECTORS' BRIEFS AND IN FURTHER SUPPORT OF TRUSTEE'S MOTION TO ESTABLISH CERTAIN PROTOCOLS AND PROCEDURES FOR REQUESTING DOCUMENTS**

[1] The debtors in these cases, along with the last four digits of their respective federal tax identification numbers are ITT Educational Services, Inc. [1311]; ESI Service Corp. [2117]; and Daniel Webster College, Inc. [5980].

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**CASES**

**STATUTES**

Deborah J. Caruso, the chapter 7 trustee (the "**Trustee**") for the above-captioned debtors (the "**Debtors**"), respectfully submits this omnibus brief in opposition to the briefs filed by each of the "**Objectors**"[1] and in further support of the *Trustee's Motion to Establish Certain Protocols and Procedures for Requesting Documents* (the "**Document Procedures Motion**") [ECF No. 1268] in accordance with this Court's May 3, 2017 *Order Establishing Briefing Schedule with Respect to Trustee's Motion to Establish Certain Protocols and Procedures for Requesting Documents and Granting Related Relief* ( the "**Scheduling Order**") [ECF No. 1602].

**Preliminary Statement**

On May 3, 2017, the Court entered its Scheduling Order, requesting that the parties brief: (a) the applicability of 28 U.S.C. § 959(b) ("**§ 959(b)**") to the Trustee's obligation (or lack thereof) to comply with certain "**State Statutes**"[2] relating to the disposition of student-related

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[1] The Objectors refer to: (a) the Texas Higher Education Coordinating Board ("**Texas**"); (b) the California Department of Consumer Affairs, Bureau for Private Postsecondary Education ("**California**"); (c) the Maryland Higher Education Commission ("**Maryland**"); (d) the Consumer Fraud Bureau of the Office of the Illinois Attorney General and the Illinois Board of Higher Education (collectively, "**Illinois**"); (e) the Board of Governors of the University of North Carolina ("**North Carolina**"); (f) the Florida Commission for Independent Education, Florida Department of Education ("**Florida**"); (f) the Missouri Department of Higher Education ("**Missouri**"); (g) the Michigan Department of Licensing & Regulatory Affairs, Bureau of Corporations, Securities & Commercial Licensing ("**Michigan**"); (h) the New York State Attorney General's Office ("**New York**"); (i) the Massachusetts Department of Higher Education ("**Massachusetts**"); (j) the Pennsylvania Office of the Attorney General and the Pennsylvania Department of Education (collectively, "**Pennsylvania**"); (k) the New Mexico Higher Education Department ("**New Mexico**"); (l) the Iowa College Student Aid Commission and the Iowa Office of Attorney General (collectively, "**Iowa**"); (m) the South Carolina Commission on Higher Education ("**South Carolina**"); (n) the Board of Regents of the University of Nebraska ("**Nebraska**"); and (r) Westchester Fire Insurance Company ("**Westchester**").

[2] The State Statutes collectively refer to: (1) 19 Tex. Admin. Code § 7.4(a)(19); (2) 19 Tex. Admin. Code § 7.5(d); (3) Cal. Educ. Code § 94900; (4) Cal. Educ. Code § 94900.5; (5) Cal. Educ. Code § 94927.5; (6) Cal. Code Regs. tit. 5, § 71920; (7) Cal. Code Regs. tit. 5, § 71930(f); (8) Neb. Rev. Stat. §§ 85-173–75; (9) MD. Code Ann., Educ. §§ 11-105(n), 11-402 (LexisNexis 2017); (10) MO. Ann. Stat. § 173.604.2(16); (11) MO. Code Regs. Ann. tit. 6 § 10-5.010(8)(D)-(E) (West 2017); (12) 24 PA. Cons. Stat. §§ 6501-6518; (13) 22 PA. CODE §§ 73.21-73.26 (2017); (14) Mass. Gen. Laws. Ann. ch. 69, § 31B (West 2017); (15) Mich. Admin. Code, r. 390.564 (2017); (16) Ill. Admin. Code, tit. 23, § 1030.70(b)(4)(B)(v) (2012); (17) N.Y. Arts & Cult. Aff. Law §57.05 (McKinney 2017); (18) N.M. Stat. Ann. § 21-23-15 (2013); (19) N.M. Code R. § 5.100.2.33 (2005); (20) N.C. Gen. Stat. Ann. § 116-15 (West 2017); (21) Iowa Admin. Code r. 283-21.11 (2017); (22) S.C. Code Ann. Regs. 62-20(D) (2017); and (23) Fla. Stat. § 1005.36.

records, including, *inter alia*, transcripts, diplomas and education verifications (collectively, the "**Student Records**"); (b) the meaning of the phrase "manage and operate" within § 959(b); and (c) assuming that § 959(b) applies to the Trustee (which it does not), does Indiana's law apply because the Student Records are currently located in Indiana or should the Court apply the laws of each state where the Student Records were located prior to their relocation to Indiana.

As a preliminary matter, the Trustee feels it necessary to address some of the Objectors' false caricature of her as some uncaring monster with a blow torch in hand waiting to incinerate the Student Records immediately upon obtaining a determination by this Court that § 959(b) does not require the Trustee to comply with the State Statutes. The actual facts could not be further from the truth. The Trustee does not now and never previously had any intention of abandoning or destroying any Student Records so as to put them beyond the reach of ITT's former students. To the contrary, since her appointment as Trustee, she has taken great pains to preserve the Student Records from possible destruction resulting from the negligent or intentional acts of the Debtors' landlords, former employees or others, including by digitizing records to the extent feasible and cost-effective. (ECF No. 1268 at 4 and 6) Indeed, to the extent the Trustee has suggested that she may "abandon" any Student Records, it has always been in the context of turning them over to Indiana (which could then negotiate with the respective states and students to obtain access thereto) or to the Objectors themselves. At no time did the Trustee indicate that she intended to destroy the Student Records. Moreover, when and if the Trustee ever does seek permission to "abandon" the Student Records (because they have no value to the Debtors' estates and are too burdensome to maintain), she will do so in accordance with 11 U.S.C. § 554, at which time the Objectors may raise any concerns they may have to the Trustee's proposed course of action.

In short, there is no real dispute that the Student Records should be preserved for the benefit of ITT's former students. The only issue is who should pay for it, with the Objectors claiming that the Debtors' estates should bear 100% of such costs and pay them on a priority basis ahead of all other creditors on the theory that they relate to the Trustee's "management and operation" of the Debtors' property under § 959(b).

Turning to the issues that the Court requested the parties to brief, the short answer is that the State Statues are inapplicable to the Trustee on their face because the Trustee is neither an educational institution nor an officer, director or owner of an educational institution. The State Statutes are also inapplicable to the Trustee under § 959(b), as the Seventh Circuit in *S.E.C. v. Wealth Mgmt. LLC*, 628 F.3d 323, 334 (7th Cir. 2010), has definitively held that § 959(b) is not applicable to liquidating trustees – like the Trustee here. The holding in *Wealth Mgmt.* is binding precedent. In addition, the courts that have analyzed the "manage and operate" language in § 959(b) have confirmed the holding and analysis in *Wealth Mgmt.* As one Indiana federal court succinctly stated:

> The critical provision in this sub-paragraph is the phrase "manage and operate". First, it is the Court's view that sub-paragraphs (a) and (b) operate in parallel universes, i.e., one in which the trustee is actually conducting business on the property. In the context of a Chapter 7 case, this concept entails an order pursuant to 11 U.S.C. § 721 [an authorization to operate business] and does not encompass a situation in which a Chapter 7 trustee inherits a facility on which the business engaged in by the debtor is no longer conducted.

*In re Globe Bldg. Materials, Inc.*, 345 B.R. 619, 637 (Bankr. N.D. Ind. 2006).

Since § 959(b) is inapplicable to the Trustee, there is no need to engage in any further analysis to determine which State Statutes apply (*i.e.*, the State Statute of each state where any Student Records were located as of the Petition Date or Indiana's State Statute since all of the Student Records are currently located in Indiana). However, even if this were other than a purely academic exercise, the plain language of § 959(b) mandates that Indiana law applies. § 959(b)

states that non-liquidating trustees, who are operating a debtor's business, must apply the law of the state where the debtor's property "***is***" located – not where it "***was***" located as of the petition date or any other date.

Moreover, since § 959(b) is inapplicable here, the Objectors have no viable claim (administrative or otherwise) arising from any post-petition "failure" by the Trustee to comply with the State Statutes. In addition, the post-petition costs to access and retrieve the Student Records do not constitute an administrative claim, since they are not "actual, necessary costs and expenses of preserving" the Debtors' estates under 11 U.S.C. § 503(b)(1)(A). Lastly, to the extent there was any pre-petition non-compliance by the Debtors with any of the State Statutes, the case law cited by the Objectors (*e.g., In re Computer Learning Ctrs., Inc.*, 298 B.R. 569 (Bankr. E.D. Va. 2003)) confirms that the Objectors are pre-petition unsecured creditors and will be paid according to the hierarchy set forth in 11 U.S.C. § 726 to the extent there are available assets.

For these reasons and those discussed in detail below, the relief sought by the Trustee in the Document Procedures Motion should be granted and the objections raised by the Objectors overruled, and the "Issue," as defined in the Scheduling Order,[3] should be resolved in the Trustee's favor.

**Background**

On September 6, 2016, ITT announced that it was permanently shutting down its academic operations at its approximately 137 campuses located in 39 states, as well as its online

[3] The Issue, as set forth in the Scheduling Order, was determining the "procedure for resolving the proper party or parties to pay for each of the states' access to applicable [Student Records], and whether any state (or agency thereof) is entitled to an administrative expense claim under section 503 of the Bankruptcy Code for costs incurred in accessing the [Student Records] under the Request Procedures or otherwise."

programs, and terminating the overwhelming majority of its more than 8,000 employees. Ten days later, on September 16, 2016 (the "**Petition Date**"), the Debtors filed voluntary petitions for relief under chapter 7 of title 11 of the United States Code (the "**Bankruptcy Code**") in this Court. That same day, the Trustee was appointed interim chapter 7 trustee in each of the bankruptcy cases pursuant to § 701(a)(1) of the Bankruptcy Code, and became the case trustee in each of the Debtors' bankruptcy cases following the conclusion of the first meeting of creditors on November 1, 2016, pursuant to § 702(d) of the Bankruptcy Code.

On September 29, 2016, the Trustee filed her *Motion for Authority to Allow Access to the Affiliated Debtors' Books, Records and Other Documents* [ECF No. 173] (the "**Records Motion**"). The Records Motion sought authority to, *inter alia*: (a) allow certain entities (defined in the Records Motion as "**Providers**") access to various records of the Debtors, including Student Records, to "image, collect, cull, organize, manage and otherwise process" such records; and (b) "to charge interested parties reasonable access and search fees in connection with accessing any of the Student Records maintained on any databases developed by the Providers or otherwise maintained by the Trustee." No objections were filed, and an order granting the relief requested in the Records Motion was entered by the Court on October 4, 2016 [ECF No. 217] (the "**Records Order**"). No party appealed the Records Order.

On October 3, 2016, the Trustee filed an application [ECF No. 209] (the "**Tiger Application**") authorizing the Trustee to engage Tiger Capital Group, LLC ("**Tiger**") to safeguard, assemble and transport documents (including the Student Records) and other materials from each of the Debtors' locations to a warehouse maintained by GRM Information Management Services, Inc. ("**GRM**"), located in Indianapolis, Indiana. The principal purposes of the Tiger Application were to safeguard the Debtors' records and facilitate the Trustee's

ability to sell the Debtors' real estate holdings and reject various leases for other locations, thereby saving millions of dollars that would otherwise need to be spent as administrative expenses to maintain such facilities. On October 6, 2016, a hearing was held on the Tiger Application and the Court entered an order [ECF No. 255] (the "**Tiger Order**") granting the relief requested in the Tiger Application. No party appealed the entry of the Tiger Order. Since the Petition Date, Tiger has gathered over 66,000 boxes of documents (including Student Records), all of which are currently held at GRM's warehouse in Indianapolis.

On February 20, 2017, the Trustee filed the Document Procedures Motion seeking to establish certain protocols and procedures for students, states and regulatory agencies to request Student Records from the Debtors, at their own expense. The question now before this Court is whether the Debtors' estates must bear these expenses of providing or obtaining access to the Student Records under § 959(b). The answer, pursuant to controlling authority in the Seventh Circuit, is a resounding "no".

## ARGUMENT

### I. The State Statutes Are Facially Inapplicable to the Trustee

None of the State Statutes on their face apply to a chapter 7 trustee. In fact, only twelve of the State Statutes impose an affirmative obligation for an educational institution to turn over Student Records to a state entity upon ceasing operations.[4] Of these twelve statutes, five identify the specific individual/entity whose duty it is to turn over the records: (a) Texas, Maryland and

[4] Turning over Student Records is optional under the Nebraska statute. *See* R.R.S. Neb. § 85-173 ("The trustees or officers of any college or other institution of learning … upon going out of existence or ceasing to function as an educational institution, ***may turn over*** its records of all grades, attained by its students, to the registrar of the University of Nebraska"). The North Carolina and New York statutes are statutes of general record keeping and do not require a closed educational institution to turn over Student Records at all. *See* N.C. Gen. Stat. § 116-15(f)(8) (general provision requiring schools to maintain adequate records of students in order to remain licensed); N.Y. C.L.S. Art & Cult Affr. § 57.05 (state archives law generally).

New Mexico impose this duty on the educational institution's chief administrative officer; (b) Massachusetts imposes this duty on any officer of the institution; and (c) Florida imposes this duty on any officer, director, owner, administrator or the institution itself. (*See* 19 Tex. Admin. Code § 7.5(d); MD. Code Ann., Educ. § 11-401(a); N.M. Code R. § 5.100.2.33; Fla. Stat. § 1005.36(2-3); Mass. Gen. Laws. Ann. § 388.1014a(1).) The remaining State Statutes only provide that the educational institution, itself, must arrange for the Student Records to be turned over to a designated state entity. (*See* Cal Ed Code § 94927.5(a)(1); Mo. Ann. Stat. § 173.604.2(16); 24 P.S. §6504(b); ALM GL ch. 69, § 31B; 23 Ill. Adm. Code 1030.70(b)(4)(B)(v); 283 IAC 21.11(1); S.C. Code Regs. § 62-20(D)). The Trustee, however, is not an officer, director, owner or administrator of ITT. Nor, is the Trustee an educational institution. Simply stated, the Trustee does not have to turn over the Student Records to the Objectors because, as written, the State Statutes do not apply to her.

## II. 28 U.S.C. § 959(b) Does Not Apply to the Trustee

### A. Binding Seventh Circuit Precedent Holds That § 959(b) Does Not Apply to Liquidating Trustees

Because the State Statutes are facially inapplicable to the Trustee, the Objectors must rely on § 959(b) for their argument that they should apply to her. The fundamental flaw in this argument is that the Seventh Circuit has definitively held that § 959(b) does ***not*** apply to liquidating trustees. *Wealth Mgmt. LLC*, 628 F.3d at 334.[5] Since *Wealth Mgmt.* constitutes

[5] In *Wealth Mgmt.*, certain investors in an investment fund objected to a receiver's proposed plan to distribute the fund's remaining assets among its investors on a pro-rata basis. Invoking § 959(b), the objecting investors claimed that the receiver was required to distribute the fund's assets in accordance with state law. Under the relevant state statute, an investor who had previously sought to redeem his or her investment was considered a creditor with priority status over a non-redeeming investor who was considered equity. In affirming the District Court's rejection of the objecting investors' argument, the Seventh Circuit held that "because liquidation was not 'a continuance of the business,' the statute did not apply to liquidations." *Id.* at 334.

binding precedent and there is no dispute that the Trustee is a liquidating trustee who has not operated and is not operating the Debtors' former business of providing for-profit education, the Court need go no further in order to reject the Objectors' argument that the Trustee must comply with the State Statutes pursuant to § 959(b).

The Objectors urge this Court to ignore *Wealth Mgmt.*, suggesting that it does not apply to bankruptcy trustees at all and/or is an outlier decision not in accord with other federal court decisions interpreting § 959(b). This argument ignores the wealth of decisions both inside and outside the Seventh Circuit that, consistent with the decision in *Wealth Mgmt.*, hold that § 959(b) is inapplicable to liquidating trustees.

For example, the holding in *Wealth Mgmt.* is consistent with other decisions in this Circuit that both pre- and post-date *Wealth Mgmt. See, e.g.*, *United States v. Zabka*, 900 F. Supp.2d 864, 868-69 (C.D. Ill. 2012) (citing *Wealth Mgmt.* and holding that § 959(b) does not apply to liquidating trustees or receivers appointed to inventory partnership property and manage that property in order to arrange for a sale thereof or other liquidations); *In re Globe Bldg. Materials, Inc.*, 345 B.R. at 636-37 (collecting cases and stating that by far the overwhelming authority established by federal courts is that § 959(b) does not apply to the trustee in a chapter 7 case unless the trustee continues to operate the debtor's business).

Not only is *Wealth Mgmt.* consistent with other decisions in this Circuit, it is also in line with the overwhelming majority view among federal courts that have addressed the applicability of § 959(b) to liquidating trustees. *See In re Lehal Realty Assocs.*, 101 F.3d 272, 276 (2d Cir. 1996) ("We agree … that § 959 does not apply where, as here, a trustee acting in his official capacity conducts no business connected with the property other than to perform administrative tasks necessarily incident to the consolidation, preservation, and liquidation of assets in the

debtor's estate."); *In re N.P. Mining Co., Inc.*, 963 F.2d 1449, 1450 and 1460-61 (11th Cir. 1992) (holding that § 959(b) did not apply when a strip mining company's operations had ceased and its assets were being liquidated); *Saravia v. 1736 18th St., N.W., LP*, 844 F.2d 823, 827 (D.C. Cir. 1988) (viewing § 959(b) "as applying only to operating businesses, not ones that were in the process of being liquidated"); *In re Gardens Reg'l Hosp. & Med. Ctr., Inc.*, Case No. 2:16-bk-17463-ER, 2017 WL 2080241, *7 (Bankr. C.D. Ca. May 15, 2017) (rejecting California Attorney General's argument that a liquidating trustee's sale of a hospital must comply with various state law regulations and citing to *Wealth Mgmt.* for the proposition that "§ 959(b) applies only when the Debtor continues to operate its business, and does not apply where, as here, the Debtor is liquidating its assets."); *In re Old Carco LLC*, 424 B.R. 650, 661-62 (Bankr. S.D.N.Y. 2010) (holding that § 959(b) does not require a liquidating trustee who is no longer actively operating the debtor's business to comply with state's comprehensive regulatory scheme enacted pursuant to its "police powers" to address public health, safety and general economic welfare to address the disparity between automobile manufacturers and dealers); *In re Old Carco LLC*, 424 B.R. 633, 647-49 (Bankr. S.D.N.Y. 2010) (same); *In re St. Lawrence Corp.*, 239 B.R. 720, 725-26 (Bankr. D.N.J. 1999) (holding that § 959(b) does not require a liquidating trustee to comply with state environmental laws relating to the abandonment of property); *In re Valley Steel Prods. Co., Inc.*, 157 B.R. 442, 447-48 (Bankr. E.D. Mo. 1993) (holding that § 959(b) does not apply to a liquidating trustee, and excusing the trustee's compliance with certain monitoring and reporting obligations under state environmental laws and financial assurances associated therewith); *In re Corona Plastics, Inc.*, 99 B.R. 231, 235-36 (Bankr. D.N.J. 1989) (holding that § 959(b) does not apply to a liquidating trustee, and excusing the trustee's compliance with state environmental laws); *In re Scott Hous. Sys., Inc.*, 91 B.R, 190, 195-96 (Bankr. S.D.Ga. 1988)

(holding that § 959(b) does not apply to liquidating trustees); *In re Catamount Dyers, Inc.*, 50 B.R. 790, 794 (Bankr. D. Vt. 1985) (holding that § 959(b) has no application to a trustee whose only function is to liquidate assets); *In re Borne Chem. Co., Inc.*, 54 B.R. 126, 135 (Bankr. D.N.J. 1984) (holding that liquidating trustee did not have to comply with state environmental laws concerning the sale property as "§ 959(b) is applicable only where the property is being managed or operated for the purpose of continuing operations, which is not the case under the present circumstances").

The Objectors seek to distinguish *Wealth Mgmt.* in three ways, each of which is meritless. First, Westchester argues that § 959(b) applies to liquidating trustees because it contains a carve-out for railroad trustees pursuant to 11 U.S.C. §1166. Not so. 11 U.S.C. § 1166 simply provides that ***all*** trustees and debtors must comply with all federal, state and local regulations related to railroads. Unlike § 959(b), there is no "manage and operate" language in 11 U.S.C. § 1166. Thus, by carving out railroads from § 959(b), Congress intended only that liquidating ***railroad*** trustees must comply with railroad-related regulations under 11 U.S.C. § 1166, not that the statute should apply to liquidating trustees of non-railroad businesses.

Second, Westchester claims that § 959(b) should apply to liquidating trustees because liquidating bankruptcy estates are obligated to pay state taxes under 28 U.S.C. § 960(a). This argument is equally flawed. 28 U.S.C. § 960(a) simply provides that ***all*** officers and agents (including liquidating bankruptcy trustees) conducting any business under the authority of a U.S. Court are subject to all "Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation."[6] Similar to 11 U.S.C. § 1166,

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[6] Indeed, Westchester's reliance on *Cal. State Bd. Of Equalization v. Sierra Summit*, 490 U.S. 844, 852 (1989) is misplaced. As the Supreme Court explained, § 960(a) was enacted to overrule a decision that interpreted the

Congress intended only that liquidating trustees must pay applicable "Federal, State and local taxes," not that liquidating trustees must comply with all other state laws.

Third, the Objectors contend that *Wealth Mgmt.* is explicitly limited to state laws and regulations that do not implicate the health, safety and welfare of the general public. However, nothing in *Wealth Mgmt.* purports to impose any such limitation on the Seventh Circuit's holding that § 959(b) is inapplicable to liquidating trustees. The Objectors base their argument on a solitary footnote in *Wealth Mgmt*, but its precise language does not support the Objectors' argument. Specifically, the Seventh Circuit stated that:

> We note that the Sixth Circuit has suggested ***in dicta*** that § 959(b) requires receivers to comply with state law regardless of whether the receiver is liquidating an estate or actively managing it. *See In re Wall Tube & Metal Prods. Co.*, 831 F.2d 118, 122 (6th Cir.1987). We think *Wall Tube* must be read in light of its facts. The case involved the cleanup of an environmental accident and the applicability of state laws governing the disposal of hazardous waste; ***it appears that the Sixth Circuit meant to suggest only that §959(b) requires a liquidating receiver to comply with state laws regulating public health, safety, and welfare when liquidating receivership property***. *See id.* In *Midlantic National Bank v. New Jersey Department of Environmental Protection,* 474 U.S. 494, 505, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986), the Supreme Court explicitly declined to decide whether § 959(b) applies to liquidations.

*Id.*, 628 F.3d at 334, n.7 (emphasis added). As the footnote makes plain, the Seventh Circuit simply confirmed that the ***Sixth Circuit held*** that "§ 959(b) requires a liquidating receiver to comply with state laws regulating public health, safety, and welfare when liquidating receivership property."

Notably, the Seventh Circuit did not (a) adopt the Sixth Circuit's suggestion (in dicta) that § 959(b) applies to liquidating trustees in general or (b) recognize the Sixth Circuit's carve-out for state laws regulating the health, safety and welfare of the general public. Moreover, the

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intergovernmental tax immunity doctrine to hold a state could not tax a bankruptcy receiver operating a business. *Id.* at 852.

Seventh Circuit expressly noted that the Supreme Court's decision in *Midlantic Nat'l Bank v. N.J. Dep't of Envt'l Prot.*, 474 U.S. 494 (1986), applied solely in the context of a trustee's abandonment power under 11 U.S.C. § 554 and the Supreme Court "***explicitly declined to decide whether §959(b) applies to liquidations.***" *Wealth Mgmt., LLC*, 628 F.3d at 334, n.7 (emphasis added). Accordingly, there is no basis for the Objectors' contention that the Seventh Circuit adopted the reasoning or conclusion of the Sixth Circuit in *In re Wall Tube & Metal Prods. Co.*, 831 F.2d 118 (6th Cir. 1987), or its progeny.[7]

In any event, even if the Seventh Circuit did recognize the Sixth Circuit's "public health, safety and welfare exception" (which it has not), such exemption is inapplicable here for the following reasons:

- First, the Objectors have not cited a single decision (and concede that there are none) holding that state laws regulating the maintenance of Student Records constitute laws regulating public health, safety and welfare for § 959(b) purposes.[8] Indeed, the few cases

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[7] The Objectors' reliance on *In the Matter of H.L.S. Energy Co., Inc.*, 151 F.3d 434 (5th Cir. 1998) is similarly inapplicable as it relies on the same Sixth Circuit analysis that was rejected by the Seventh Circuit in *Wealth Mgmt.* Moreover, it appears that some of the liability in *H.L.S. Energy* arose post-petition when the chapter 11 trustee was operating the debtor's business before the case was converted to a chapter 7 proceeding. As such, the decision's holding is inapplicable to situations exclusively involving a liquidating trustee who never operated the debtor's business – as is the case here. Similarly, the Objectors' attempt to draw comparisons to the *Corinthian Colleges* bankruptcy cases is also unavailing as the *Corinthian Colleges* cases were under chapter 11, and the applicable debtors continued operations as a going concern, in stark contrast to the facts presented by the Debtors' chapter 7 cases. Moreover, the proposed motion and order in the *Corinthian College* cases (annexed as Exhibits A-B to California's brief) nowhere mention § 959(b) or its supposed applicability to student records. Further, in *Corinthian Colleges*, certain student records ***were*** abandoned. Thereafter, the students formed a group and found a trustee to administer the records for their benefits. In short, any voluntary actions taken by or proposals affirmatively made by the chapter 11 trustee in *Corinthian College* are simply not relevant here.

[8] By analogy, Texas argues that 11 U.S.C. § 351 dealing with the disposition of patient records shows that, absent a specific statutory exemption, all other records must be preserved by liquidating trustees. Texas, however, cites no authority that has relied upon § 351 as a basis to require the application of § 959(b) to other types of records – much less student records. Moreover, had Congress intended to provide the same protections in bankruptcy to Student Records, it could have made the provision applicable to educational institutions or provided similar protections for such records. However, by its explicit terms, § 351 applies only to "health care businesses," which the Debtors were and are not. *See* 11 U.S.C. § 101(27A).

applying a "public health, safety and welfare exception" to the rule that § 959(b) does not apply to liquidating trustees have mostly been in the environmental context. *See, e.g.*, *In re Wall Tube & Metal Prods. Co.*, 831 F.2d 118; *In the Matter of H.L.S. Energy Co., Inc.*, 151 F.3d 434; *cf. In re Gardens Reg'l Hosp. & Med. Ctr., Inc.*, 2017 WL 2080241 at *7 (rejecting California Attorney General's argument that a liquidating trustee's sale of a hospital must comply with various state law regulations); *In re Old Carco LLC*, 424 B.R. at 647-49 (holding that § 959(b) does not require a liquidating trustee that is no longer actively operating the debtor's business to comply with state's comprehensive regulatory scheme enacted pursuant to its "police powers" to address the disparity between automobile manufacturers and dealers).

The Objectors' reliance on *Computer Learning* is not to the contrary; it actually ***supports*** the Trustee's position. In *Computer Learning*, a trustee of a defunct computer training center agreed to transfer Student Records from four California schools to California – ***at California's expense***. 298 B.R. at 572. Significantly, nowhere does *Computer Learning* address the applicability of § 959(b) to a liquidating trustee; in fact, § 959(b) is nowhere mentioned at all in that case. The fact that the trustee in that case voluntarily, through an agreement with California, undertook to review and turn over Student Records to California – ***at California's expense***, does not mean that a liquidating trustee is ***obligated*** to do so under § 959(b) – much less bear the cost of doing so.

- Second, the State Statutes regulating the maintenance and destruction of the Student Records simply do not implicate the safety, health and welfare of the general public. For example, in stark contrast to state environmental laws where non-compliance may have long-lasting implications on the health and safety of a state's citizens in general (*e.g.*, contamination of the state's air and public drinking water), non-compliance with state record-keeping laws

would have no similar calamitous effect on the general public's health, welfare or safety. Moreover, the Tiger Order sufficiently protects the rights of ITT's students concerning the preservation of the Student Records by requiring Tiger to, among other things, "oversee and coordinate 3rd party services related to the storing of the [Debtors'] records from the business locations." (*See* ECF No. 255-1, §§ 1(a)(ii-iii), 2 and 4(b-c).)

- Third, to the extent the Objectors seek to apply the public safety, health and welfare exception that the Supreme Court applied to a trustee's abandonment power under 11 U.S.C. § 554, it must also apply the Supreme Court's limited scope of that exception. For instance, the Supreme Court in *Midlantic* cautioned that its proposed limitation on a trustee's abandonment power "must be reasonably designed to protect the public health or safety from identified hazards." 474 U.S. at 507. The Supreme Court further qualified its holding by stating that "[t]his exception to the abandonment power vested in the trustee by § 554 is a narrow one. It does not encompass a speculative or indeterminate future violation of such laws that may stem from abandonment. The abandonment power is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from ***imminent and identifiable harm***." *Id.* at 507, n.9 (emphasis added). By way of example, the Supreme Court noted that abandonment in that case would present risks of explosion, fire, contamination of water supplies, genetic damage, death and other dangers. *Id.* at 499, n.3; *see also In re L.F. Jennings Oil Co.*, 4 F.3d 887, 890-91 (10th Cir. 1993) (holding that *Midlantic's* narrow exception to trustee's abandonment power under 11 U.S.C. § 554 did not apply where the record shows that (1) the debtor's property was not listed on the state's list of contaminated sites, (2) there was insufficient data from which the state's own expert could state that debtor's property was a present threat, and (3) the trustee's only violation of state law at the time of abandonment was failure to file

reports.); *In re Smith-Douglass, Inc.*, 856 F.2d 12, 16 (4th Cir. 1988) ("[T]his narrow exception applies where there is ***a serious health risk***, not where the hazards are speculative or may await appropriate action by an environmental agency.") (emphasis added); *In re Howard*, 533 B.R. 523, 547 (Bankr. S.D. Miss. 2015) (permitting trustee to abandon property under 11 U.S.C. § 554 where the purported contamination of the subject property "does not present an imminent and identified harm to the public health and safety that would warrant the application of *Midlantic's* narrow exception to the Trustee's abandonment powers").

Here, the Objectors argue that the Trustee should be bound to follow the State Statutes because protection of the Student Records is vital to the students' ability to transfer their educational credits to other institutions of higher learning and to securing employment and scholarships. Such concerns, however, are ameliorated by the Tiger Order, which sufficiently protects the Student Records and rights of ITT's students (and effectively, the Trustee) by requiring Tiger to, *inter alia*, "oversee and coordinate 3rd party services related to the storing of the [Debtors'] records from the business locations." (*See* ECF No. 255-1, §§ 1(a)(ii-iii), 2 and 4(b-c).)[9] As mentioned above, the Student Records are secure and located in GRM's Indianapolis warehouse, and pursuant to this Court's order (ECF No. 1490), students can voluntarily comply with the procedures set forth in the Document Procedures Motion to obtain a copy of their Student Records from GRM. In any event, the future needs of ITT students to access their Student Records – although important – cannot be said to rise to the level of imminent harm, as the Trustee has not and is not imminently proposing to destroy the Student Records, and instead has offered to allow the States – at their expense – to review and take any

[9] And, in fact, the Student Records retrieved by Tiger from ITT's business and storage locations are currently stored at GRM's secure warehouse in Indianapolis.

Student Records they deem necessary to satisfy the "concerns" espoused in their respective State Statutes.

- Fourth and related, the Objectors are not truly concerned about the destruction of the Student Records. Rather, their overt concern is and always has been that they will have to bear the cost of accessing the Student Records. The issue before this Court is not whether the Student Records will be available to ITT's students in the future, but rather only who will pay for the cost of making them available. As such, the Objectors' argument must fail because the Supreme Court's opinion in *Midlantic*, upon which the Objectors' argument is based, is ***"intended to fashion a narrow exception ... to protect public safety rather than a broad exception to shield the state treasury."*** *In re Smith-Douglass, Inc.*, 856 F.2d at 16 (emphasis added).

### B. Section 959(b)'s "Manage and Operate" Language Supports The Seventh Circuit's Holding That The Statute Does Not Apply to Liquidating Trustees

The Seventh Circuit's holding that § 959(b) does not apply to liquidating trustees is supported by the "manage and operate" language in that statute. As the Bankruptcy Court for the Northern District of Indiana in *In re Globe Bldg. Materials Inc.*, succinctly explained:

> Sub-paragraph (a) of [§ 959] provides a rule by which a bankruptcy trustee may be sued "with respect to any of [his/her] acts or transactions in carrying on business connected with [property of the estate]", without the plaintiff's first seeking relief from the automatic stay. The critical element of this provision is that it relates only to "transactions in carrying on business"; it does not relate to actions directed against the trustee solely because certain property is property of the bankruptcy estate. Sub-paragraph (b) of [§ 959] then states that a trustee "shall manage and operate the property in his possession as such trustee ... according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof". ***The critical provision in this sub-paragraph is the phrase "manage and operate". First, it is the Court's view that sub-paragraphs (a) and (b) operate in parallel universes, i.e., one in which the trustee is actually conducting business on the property. In the context of a Chapter 7 case, this concept entails an order pursuant to 11 U.S.C. § 721 [an authorization to operate business] and does not encompass a situation in which a Chapter 7 trustee inherits a facility on which the business engaged in by the debtor is no longer conducted.***

345 B.R. at 636-37 (emphasis added).

Other courts have similarly construed the "manage and operate" language in § 959(b). For instance, in *In re Scott Hous. Sys., Inc.*, 91 B.R. at 196, the court held that:

> The 'manage and operate' language of [§] 959(b) when read in conjunction with [§] 959(a), which provides in relevant part that: 'Trustees, receivers or managers of any property, including debtors in possession, may be sued ... with respect to any of their acts or transactions *in carrying on business* connected with such property" (emphasis added), evidences a statutory intent that [§] 959 applies when the business is being operated, not when its operations have ceased and its assets are being liquidated.

*See also In re Valley Steel Prods. Co., Inc.*, 157 B.R. at 447-48 (same).

In terms of their plain and ordinary meaning, the court in *In re Catamount Dyers, Inc.*, stated that § 959(b):

> applies specifically to a trustee who is managing and operating the property in his possession as trustee. ***The words "manage" and "operate" in the statute indicate affirmative action. To manage means "to direct or carry on business or affairs" and to operate means "to perform a function; to produce an appropriate effect." See Websters New Collegiate Dictionary.***

50 B.R. at 794 (emphasis added).

Adopting and bolstering the above analysis, the Seventh Circuit, quoting the preeminent legal scholar Judge Learned Hand, stated that:

> Just as an owner or possessor of property is required to comply with state law, so too must ***a receiver comply with state law in the "management and operation" of the receivership property in his possession***... Long ago, the Second Circuit read § 959(b)'s predecessor statute in this way. The court noted that liquidation was "[m]erely to hold matters in statu[s] quo; to mark time, as it were; to do only what is necessary to hold the assets intact." *Vass v. Conron Bros. Co.*, 59 F.2d 969, 971 (2d Cir.1932) (Hand, J). Accordingly, ***because liquidation was not "a continuance of the business," the statute did not apply to liquidations.*** *Id.*

*Wealth Mgmt. LLC*, 628 F.3d at 334 (emphasis added).

The Objectors essentially ignore all of this. Instead, they ask this Court to assume "manage and operation" should include "managing" the Student Records that the Trustee

gathered to prevent them from being lost or destroyed. Such an assumption is contrary to the analysis and conclusion of the courts both inside and outside the Seventh Circuit that have analyzed the "manage and operate" language of § 959(b) and is directly contrary to the Seventh Circuit's holding in *Wealth Mgmt.* that § 959(b) does not apply to liquidating trustees. Indeed, adopting the Objectors' interpretation of "manage and operate" would eviscerate the holding in *Wealth Mgmt.*, as every trustee for a debtor (whether the debtor is a business or a natural person) has records that would need to be maintained during the pendency of the bankruptcy case.

### C. The Objectors Are Not Entitled To An Administrative Claim For The Costs They May Incur To Retrieve The Student Records Or Make Them Accessible To Students

The Objectors contend that the costs they may incur to retrieve the Student Records or make them accessible to former ITT students constitute administrative expenses under 11 U.S.C. § 503(b)(1). They are wrong.

First, since § 959(b) is inapplicable for the reasons discussed above, there can be no claim (administrative or otherwise) arising from any alleged post-petition "failure" by the Trustee to comply with the State Statutes. *See Computer Learning Ctrs., Inc.*, 298 B.R. at 572 (refusing to grant administrative expense for moving costs, personnel travel expenses, storage expenses and document conversion expenses related to the transfer of Student Records); *see also In re Allen Care Ctrs., Inc.*, 96 F.3d 1328, 1331 (9th Cir. 1996) (refusing to grant Oregon administrative expense claim for the costs incurred by state court-appointed trustee in closing nursing home operated by chapter 7 debtor and transferring residents to other facilities where "the Department's expenses resulted, not from any post-petition wrongdoing, but simply from Allen Care's insolvency").

Second, any costs incurred by the Objectors to retrieve and provide access to the Student Records are not administrative expenses as they are not "actual, necessary costs and expenses of

preserving the" Debtors' estates under 11 U.S.C. § 503(b)(1)(A). To qualify as an actual and necessary expense, (a) the claim must arise out of a post-petition transaction with a trustee and (b) the claimant must supply consideration that is beneficial to the bankruptcy estate. *In re Jartran, Inc.*, 732 F.2d 584, 586-587 (7th Cir. 1984); *In re Merry-Go-Round Enters, Inc.*, 180 F.3d 149, 157 (4th Cir. 1999). "The administrative expense exception is intended 'to encourage and reward creditors who do business with an entity after it becomes insolvent.'" *In re Motel Invs. of Christiansburg LLC*, 307 B.R. 536, 539 (Bankr. W.D. Va. 2004); *see also*, 4 Collier on Bankruptcy ¶ 503.06[3][a] (16th ed. 2015) (explaining that to satisfy the standard for administrative expense status a creditor must engage in a post-petition transaction with the estate in a manner that benefits the estate). *See, e.g.*, *In re Johnston*, No. 11-3242-RLM-11, 2013 WL 1337757, *2 (Bankr. S.D. Ind. Mar. 29, 2013) (rejecting ex-wife's claim to characterize expenses she incurred to protect her own interest in jointly owned condo as administrative expenses because such expenses provided no benefit to the estate as a whole). Here, the Student Records are not necessary to the administration (*i.e.*, liquidation) of the Debtors' estates as they provide no economic value to ITT's bankruptcy estate. Moreover, any claim the Objectors have is a pre-petition claim arising from ITT's failure to comply with its pre-petition obligations to the Objectors under the State Statutes – not from any post-petition transaction entered into with the Trustee.[10]

Texas and California nevertheless contend that, as a matter of equity, the Trustee should be forced to comply with the State Statutes under § 959(b) because the Debtors' estates

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[10] Here, the claimed obligation to turn over Student Records under the State Statutes is nothing more than a pre-petition claim because it is either (a) a prospective obligation (*i.e.*, one of the State Statutes required ITT to remit Student Records before it closed), or (b) an obligation that allegedly arises upon the closure of a school, and ITT closed all of its locations prior to filing for bankruptcy. *See* 11 U.S.C. § 101(5) (a claim is any "right to payment" or "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment").

supposedly have the funds to do so if the associated expenses are paid on an ongoing, priority basis *i.e.*, as an administrative expense. There is no legitimate basis, however, to prefer the Objectors over the Debtors' other creditors and it would not be equitable to do so. Indeed, federal courts have held that to the extent there are any damages associated with non-compliance with a state records statute –as the Objectors alleged with respect to the State Statutes at issue here – the claimant holds a pre-petition unsecured claim that is paid according to the hierarchy set forth in 11 U.S.C. § 726 to the extent there are available assets. *See, e.g., Computer Learning Ctrs., Inc.*, 298 B.R. at 572.

Third, the case law cited by the Objectors' themselves undermines their very argument and demonstrate that, at most, the Objectors are only entitled to assert a pre-petition claim. The *Computer Learning* case cited by Objectors is particularly instructive. There, as previously noted, the trustee of a defunct computer training center agreed to transfer Student Records to California at California's expense. Later, California filed an administrative claim for moving costs, personnel travel expenses, storage expenses and document conversion expenses related to the transfer of the Student Records. The Court rejected that claim, holding that – just like any other unsecured creditor – California had a pre-petition claim for the costs of the debtor's failure to comply with the relevant California Statutes. 298 B.R. at 572; *see also In re Old Carco LLC*, 424 B.R. at 659-661 (rejecting claim for an administrative expense arising out of violation of applicable state law regarding repurchase obligations in connection with the termination of automobile dealer agreements).

## III. Assuming, *Arguendo*, That § 959(b) Applies To The Trustee, Indiana's State Statute Should Apply As The Student Records Are Located in Indiana

As noted, the Court asked the parties to explain their position regarding whether, assuming that § 959(b) applied to a liquidating trustee, such a trustee must "manage and operate"

property according to the requirements of the laws of the state in which such property (a) was located as of the commencement of the case, or (b) is presently situated. (*See* Scheduling Order at 2) According to § 959(b)'s plain language, a trustee must manage and operate property in accordance with the laws of the state in which the property is currently located.

**A. If § 959(b) Applied To The Trustee, § 959(b)'s Plain Language Would Require Application of Indiana Law**

It is axiomatic that the first rule in statutory construction is to start with the plain and ordinary meaning of the statute's text. *Henson v. Santander Consumer USA Inc.*, ___ S. Ct. ___, No. 16-349, 2017 WL 2507342, at *6 (June 12, 2017) (courts "will presume ... that the legislature says what it means and means what it says"); *Our Country Home Enters., Inc. v. Comm'r of Internal Revenue*, 855 F.3d 773, 791 (7th Cir. 2017) ("When interpreting a statute, we must begin with its text and assume that the ordinary meaning of that language accurately expresses the legislative purpose"). "If the statute is unambiguous, [the] inquiry is at an end; the congressional intent embodied in that plain wording must be enforced." *Bethlehem Steel Corp. v. Bush*, 918 F.2d 1323, 1326 (7th Cir. 1990).

Here, § 959(b) provides, in relevant part, that a trustee must manage and operate property "according to the requirements of the valid laws of the State in which such property ***is situated***." (Emphases added). The use of "is" – the present tense of "be" – within the critical phrase is dispositive. It is undisputed that the property in question – the Student Records – "is situated" in Indiana. The fact that at one time the property "was" located elsewhere is irrelevant.

This is hardly a hyper-technical interpretation. Both the Supreme Court and the Seventh Circuit "have frequently looked to Congress' choice of verb tense to ascertain a statute's temporal reach." *Carr v. United States*, 560 U.S. 438, 448 (2010) (collecting Supreme Court case law); *Eli Lilly & Co. v. Nat. Answers, Inc.*, 233 F.3d 456, 467 (7th Cir. 2000) (relying on

present tense of verb used by statute to interpret statute).[11] By using the phrase "is situated," Congress has expressed its clear intention that a trustee (albeit only one who is managing and operating the debtor's business) maintain compliance with the laws of the state in which the property being managed and operated is currently situated – not the laws of states in which such property was once situated or even the laws of the state in which it was situated when the bankruptcy petition was first filed. Even Texas admits that § 959(b)'s plain language imposes a duty to comply only with the laws of the state in which the property at issue is currently situated. (*See* ECF No. 1794 at 9 (stating that "a literal reading of the statute … mean[s] where the property is currently situated")).

The statutory text used in other sections applicable to bankruptcy trustees also supports this construction.[12] Indeed, when Congress intends a bankruptcy provision to apply with respect to a state of affairs that exists as of the petition date (or at a particular time with respect thereto) – as opposed to the state of affairs that exists at present – it explicitly says so. *See, e.g.*, 28 U.S.C. § 1334(e) ("The district court in which a case under title 11 is commenced or is pending shall have exclusive jurisdiction—(1) of all the property, *wherever located*, of the debtor *as of the commencement of such case*" (emphasis added)); 11 U.S.C. § 101(7) ("The term 'community claim' means claim that arose *before the commencement of the case* . . . , whether or not there is

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[11] The "Dictionary Act also ascribes significance to verb tense. It provides that, '[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise[,] . . . words in the present tense include the future as well as the present." 1 U.S.C. § 1. By implication then, the Dictionary Act instructs that the present tense generally does not include the past." *Carr*, 560 U.S. at 448 (alterations in original). The Indiana Supreme Court has similarly relied on the use of the present tense in a statute to interpret its meaning. *See White v. Ind. Democratic Party ex rel. Parker*, 963 N.E.2d 481, 488–89 (Ind. 2012) (holding that use of present tense meant statute applied only to "current and ongoing activity").

[12] *See United States v. Berkos*, 543 F.3d 392, 396–97 (7th Cir. 2008) (noting "[t]he language and design of the statute as a whole may also provide guidance in determining the plain meaning of its provisions").

any such property *at the time of the commencement of the case*" (emphasis added)).[13] And "[w]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Smith v. Capital One Bank (USA), N.A.*, 845 F.3d 256, 260 (7th Cir. 2016)). Had Congress intended § 959(b) to require a trustee to manage and operate property in accordance with the laws of the state in which the property was located on the petition date, as opposed to where the property is presently situated, it would have included language similar to that which it used elsewhere. It did not.

Interpreting the operative date to be the Petition Date here would also run afoul of the "cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." *Marquez v. Weinstein, Pinson & Riley, P.S.*, 836 F.3d 808, 811 (7th Cir. 2016). In other words, if the petition date is automatically the operative date of a provision absent any express language, then the use of "as of the commencement of the case" in all these other provisions of the Bankruptcy Code would be rendered superfluous and a nullity.[14]

### B. The Objectors' Arguments That Choice-Of-Law Analysis Is Applicable And Policy Necessitates Ignoring § 959(b)'s Plain Meaning Are Meritless

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[13] *See also* 11 U.S.C. § 363(b)(1) (if the debtor has a policy prohibiting the transfer of personally identifiable information and "such policy is in effect *on the date of the commencement of the case*," trustee may not sell or lease personally identifiable information unless certain conditions are met (emphasis added)); 11 U.S.C. § 541(a) ("Such estate is comprised of all the following property, *wherever located* . . . (1) . . . *as of the commencement of the case*" (emphasis added)); 11 U.S.C. § 544 ("The trustee may avoid the fixing of a statutory lien . . . to the extent that such lien-- . . . (2) is not perfected or enforceable *at the time of the commencement of the case*" (emphasis added)).

[14] None of the Objectors offers any other interpretation of §959(b). All states other than California concede or assume that § 959(b)'s plain language imposes a duty to comply only with the laws of the state in which the property is currently situated. (*See* ECF No. 1794 at 9; ECF No. 1799 at 9.) California never addressed the question. (*See generally*, ECF No. 1795) Lastly, Westchester argues that the applicable state law with which a trustee is required to comply should be determined on a "case-by-case basis," and in some instances (but not all), a trustee may be required to comply with the laws of the state in which the property was located on the petition date *and* the laws where the property is presently located. (ECF No. 1802 20-21.) In so arguing, however, Westchester fails to provide any workable rule or standard to make such determinations.

Ignoring § 959(b)'s plain language, several Objectors attempt to inject choice-of-law analysis to reach their desired result. They do so without providing any explanation as to why such an analysis is warranted given the plain language of § 959(b). As this Court recognized when it issued the Scheduling Order, determining which state's law a trustee must comply with when managing and operating property depends on the temporal scope of § 959(b). And, when it comes to interpreting federal statutes, choice-of-law analysis has no place. *See In re Jafari*, 569 F.3d 644, 648 (7th Cir. 2009) (stating choice-of-law analysis only appropriate when federal law does not decide the issue).

The Objectors' policy arguments are equally unavailing. California and Westchester argue that applying the plain meaning of § 959(b) would allow liquidating trustees to "forum shop." Not true. Under the Bankruptcy Code, a liquidating trustee may not transfer property without notice and a court hearing, which is an impartial check on any purported attempt at forum shopping. Here, the Trustee requested and was granted permission by this Court to move the Student Records to Indiana, a natural and economically efficient location given that both the Trustee and the Debtors maintain(ed) their principal places of business there. In other words, no such forum shopping occurred, nor could it. The Objectors' policy argument is a belated and specious attempt to escape the ambit of this Court's Tiger Order without making a proper motion under Federal Rule of Civil Procedure ("**FRCP**") 60. (*See* discussion in Point IV, *infra*)

The Objectors' concerns regarding the application of Indiana's laws cannot overcome the plain meaning of the statute, either. *Henson*, 2017 WL 2507342, at *6 ("[I]t is never [a] [c]ourt's job to rewrite a … valid text under the banner of speculation about what Congress might have done had it faced a question that, on everyone's account, it never faced"). Moreover (and again even assuming, *arguendo*, that § 959(b) is applicable to the Trustee (which it is not)), the

application of Indiana law would not result in any inequitable scenario. Here, as noted earlier, to the extent the Trustee has suggested that she may "abandon" any Student Records, it has always been in the context of turning them over to Indiana (which could then negotiate with the respective states and students to obtain access thereto) or to the Objectors themselves.

## IV. The Objectors' Cannot Seek Relief From The Tiger Order Outside Of FRCP 60

Pursuant to the Court's Scheduling Order, to the extent any party wanted to challenge the Tiger Order or any relief provided therein, they were obligated to file a separate motion under FRCP 60.[15] (ECF No. 1602, ¶ 5) ***No party chose to do so.*** Instead, the Objectors effectively seek the same relief by asking this Court to revisit the procedures that it authorized in the Tiger Order, including the assessment and relocation of the Debtors' physical assets. (ECF No. 255, Ex. 1, §§ 2, 4) The Court, however, should not countenance such an end-run around the need to file a FRCP 60 motion. In any event, for the reasons discussed below, the Objectors cannot meet the stringent requirements under FRCP 60 to belatedly modify or void the Tiger Order.

As a preliminary matter, FRCP 60 requires that any request for relief from a final judgment, order or proceeding "***must be made within a reasonable time.***" FRCP 60(c)(1) (emphasis added). In its Scheduling Order, the Court noted that while it was setting a June 5, 2017 deadline for making FCRP 60 motions for relief from the Tiger Order, the making of a motion by that date "***does not establish that any such party has requested relief within a 'reasonable time' under [Bankruptcy Rule] 9024 and [FRCP] 60(c)")***. (ECF No. 1602 at ¶ 5 (emphasis added)) Implicit in this caveat was that the Objectors must affirmatively explain why a request for relief from the Tiger Order – nearly eight months after it was entered – was made

[15] Rule 60 is made applicable by Federal Rule of Bankruptcy Procedure 9024.

within a reasonable time.[16] Determining whether a FRCP 60 motion is timely "depends upon the facts of each case, taking into consideration the interest in finality, the reason for delay, the practical ability of the litigant to learn earlier of the grounds relied upon, and the consideration of prejudice if any to the other parties. *Kagan*, 795 F.2d at 610.

Here, the Objectors identify no justifiable reason for their delay; their filings provide no reason why they did not object to the Tiger Order shortly after it was entered; and none of the Objectors claim that they did not have notice of the Tiger Order, as would be necessary to show that they had no practical ability to learn earlier of a need to move for relief. Further, permitting any modification to the Tiger Order at this late juncture would prejudice the efficient administration of the Debtors' estates. Pursuant to the authorization granted under the Tiger Order, the Trustee expended significant sums to relocate the Debtors' physical records to Indiana and to digitize the electronic ones. Had the Objectors made timely objections to the Tiger Application, or sought to undo it under FRCP 60 shortly after it was entered, the Trustee may not have incurred these expenses. Indeed, it is possible that the Court may have ordered the Objectors to immediately take custody of the Student Records at their own expense from their original locations and/or required that the Trustee ship the Student Records directly to the various state agencies. But, instead, the Objectors stood idly by while all of these expenses were (predictably) incurred.

In addition to FRCP 60 relief being untimely, the Objectors have demonstrated no grounds under FRCP 60(b) that would permit any of them to be relieved from the Tiger Order,

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[16] Federal courts have found as little as a few months to be unreasonable. *Sudeikis v. Chicago Transit Auth.*, 774 F.2d 766, 769 (7th Cir. 1985). While FRCP 60(c) provides that any motion made after one year is *per se* unreasonable, the one-year cut-off is an "extreme limit," and a motion filed within that time period must still be made within a reasonable amount of time in order to comply with a statute. *Kagan v. Caterpillar Tractor Co.*, 795 F.2d 601, 610 (7th Cir. 1986).

*e.g.*: (a) mistake, inadvertence, surprise or excusable neglect; (b) newly discovered evidence; (c) fraud, misrepresentation or misconduct; (d) a voided judgment; (e) a satisfied, released or discharged judgment; or (f) "any other reason that justifies relief." FRCP 60(b).

- First, there has been no mistake, inadvertence, surprise or excusable neglect by any of the Objectors or the Trustee that would warrant granting relief from the Tiger Order. Under FRCP 60(b)(1), a party must claim grounds for relief that could not have been used to obtain a reversal by means of a direct appeal. *Kiswani v. Phoenix Sec. Agency, Inc.*, 584 F.3d 741, 743 (7th Cir. 2009). A mistake typically "involves an inadvertent misunderstanding of the surrounding facts and circumstances" that is not the result of a lack of diligence. *In re Rapraeger*, 534 B.R. 778, 785 (W.D. Wis. 2015) (internal quotation marks omitted). Errors of fact or law, ignorance and carelessness do not warrant relief. *See Banks v. Chicago Bd. of Educ.*, 750 F.3d 663, 667 (7th Cir. 2014); *Kagan*, 795 F.2d at 601. Here, any claim by the Objectors that they were somehow mistaken as to the effect of the Tiger Order would be insufficient because any mistake or confusion could have easily been cured though reasonable diligence on their behalf. Moreover, substantial information was provided by the Trustee as to the state of the property of the estate, including the Student Records, leading up to and following the entry of the Tiger Order,[17] thereby further undermining any argument based on mistake.

- Second, because this is not a fact-finding proceeding, the Objectors cannot argue that newly discovered evidence warrants relief from the Tiger Order under FRCP 60(b)(2) (and

[17] For example, shortly after the Tiger Order was entered, the Trustee filed a notice indicating that she had entered into an agreement with GRM to store the Debtors' records and filed a copy of such agreement as an exhibit to the notice. (ECF No. 305)

in any case, there is no "evidence" that could not have been discovered with reasonable diligence prior to the entry of the Tiger Order).

- Third, the Objectors have not raised any hint of fraud, misrepresentation or misconduct by the Trustee sufficient to satisfy FRCP 60(b)(3) – and there is none. *See Masco Corp. v. Prostyakov*, __ Fed. Appx. __, 2017 WL 1405212, *1 (Apr. 20, 2017) (affirming denial of FRCP 60(b)(3) motion and remanding for possible sanctions in filing a frivolous appeal).

- Fourth, FRCP 60(b)(4) is inapplicable as it applies only "in the rare instance where a judgment is premised on either a certain type of jurisdictional error or a violation of due process that deprives a party of notice or the opportunity to be heard." *Rapraeger*, 534 B.R. at 785086; *see also United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260, 271 (2010) (a party's failure to object, even in the face of legal error, does not render an order void and unenforceable when the party had the opportunity to object). The Objectors do not and cannot claim that they were denied notice of the Tiger Order since they had all either (i) appeared in this proceeding at the time of the Tiger Order and therefore received notifications of its entry or (ii) if a party had not appeared, such party has subsequently learned of the notice deficiency and had an opportunity to appeal the order pursuant to Federal Rule of Appellate Procedure 4(a)(6) but failed to do so. As such, FRCP 60(b)(4) cannot be used to set aside the order. *United States v. LeShore*, No. 1:05-CR-57-TLS, 2013 WL 349536, at *2 (N.D. Ind. Jan. 29, 2013).

- Fifth, there is no judgment at this point that could have been satisfied, released or discharged sufficient to qualify for relief under FRCP 60(b)(5).

- Lastly, FRCP 60(b)(6)'s catch-all provision, which authorizes relief from an order for "any other reason that justifies relief," is an extraordinary remedy that should only be granted in "exceptional circumstances." *Banks*, 750 F.3d at 668. Indeed, the "narrow operation of this

provision reinforces [the Seventh Circuit's] interest in barring the use of Rule 60(b)(6) as a substitute for direct appeal." *Id.* No such exceptional circumstances have been identified or alleged by any of the Objectors.

In light of the above, the Objectors' request for relief, which mirrors that which it would seek in a FRCP 60 motion, should be denied.

**CONCLUSION**

In light of the foregoing, the Trustee respectfully requests the Court hold that 28 U.S.C. §959(b) is inapplicable to the Trustee and that there is no basis to avoid or modify the Tiger Order. The Trustee further requests that this Court grant the Document Procedures Motion and award her such other and further relief as this Court deems just and proper.

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Dated: July 5, 2017
Indianapolis, Indiana

Respectfully submitted,

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**CERTIFICATE OF SERVICE**

I hereby certify that on July 5, 2017, a copy of the foregoing *Trustee's Brief Responding to Objectors' Briefs and in Further Support of Trustee's Motion to Establish Certain Protocols and Procedures for Requesting Documents* was filed electronically. Pursuant to Section IV.C.3(a) of the Case Management Procedures, notice of this filing will be sent to the following parties through the Court's Electronic Case Filing System. Parties may access this filing through the Court's system.

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I further certify that on July 5, 2017, pursuant to Section IV.C.3(c) of the Case Management Procedures, a copy of the foregoing *Trustee's Brief Responding to Objectors' Briefs and in Further Support of Trustee's Motion to Establish Certain Protocols and Procedures for Requesting Documents* was emailed to the following:

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**UNITED STATES BANKRUPTCY COURT**
**SOUTHERN DISTRICT OF INDIANA**
**INDIANAPOLIS DIVISION**

| | | |
|---|---|---|
| **IN RE:** | ) | **CHAPTER 7** |
| **ITT EDUCATIONAL SERVICES, INC., et al.,** | ) | **CASE NO. 16-07207 (JMC)** |
| **DEBTORS.** | ) | **JOINTLY ADMINISTERED** |

**WESTCHESTER FIRE INSURANCE COMPANY'S BRIEF IN OPPOSITION TO TRUSTEE'S MOTION TO ESTABLISH CERTAIN PROTOCOLS AND PROCEDURES FOR REQUESTING DOCUMENTS**

Comes now Westchester Fire Insurance Company and its affiliated sureties ("Westchester"), by and through its undersigned counsel, and pursuant to the Order Establishing Briefing Schedule with Respect to Trustee's Motion to Establish Certain Protocols and Procedures for Requesting Documents (the "Briefing Schedule") [Dkt. Entry No. 1602] and files this brief in opposition to the Trustee's Motion to Establish Certain Protocols and Procedures for Requesting Documents (the "Motion") [Dkt. Entry No. 1268].

Westchester has issued surety bonds relating to the operations of ITT in approximately 24 states. As further explained below, certain surety bonds issued by Westchester may cover certain costs incurred by certain state obligees relating to retention and/or delivery of academic records after the cessation of operation of the particular post-secondary educational institution that is the respective bond principal. While Westchester asserts that the extent of any such coverage is very limited and that Westchester may have no liability under the Bonds relating to the particular records that are presently being stored by the Trustee in paper form, Westchester would subrogate to the rights and priorities of any state to which Westchester makes payment under any applicable

bond. Consequently, Westchester has an interest in ensuring that all rights of its bond obligees under contract or applicable law are preserved, even while Westchester may take the position that such obligees have no valid claims under the bonds. Westchester expressly reserves all of its rights with regard to any claims made or to be made under the Bonds.

In light of the contingent nature of Westchester's interest in the handling of the student records, this brief shall address the applicability of 28 U.S.C. § 959(b) to the Trustee, the meaning of the terms "manage and operate" as used in 28 U.S.C. § 959(b) and the operative date for determining which state's law is applicable in determining "the State in which such property is situated" under 28 U.S.C. § 959(b). Since Westchester does not represent any of the respective states and is not presently subrogated to the rights of any state, Westchester is not in a position to argue the applicability of any particular state law.

## SUMMARY OF ARGUMENT

The issue of whether 28 U.S.C. § 959(b) is applicable to bankruptcy trustees in liquidating cases is the central issue before the Court. Fortunately, in addition to clues in the statutory language itself, the Court can rely upon Supreme Court precedent addressing similar and related sections of the U.S. Code for guidance. Upon analysis of the same, the only viable conclusion that is consistent with the statutory language and Supreme Court precedent is that 28 U.S.C. § 959(b) does indeed apply to chapter 7 liquidating trustees.

First, 28 U.S.C. § 959(b) and 11 U.S.C. § 1166 are sister statutes that require trustees to comply with state law – the latter applies to trustees in railroad cases and the former applies to all other trustees. In Section 1166, Congress expressly exempted trustees if the trustees were abandoning property in accordance with the abandonment provision applicable in railroad bankruptcy cases. In Section 959(b), Congress included no such exemption. The clear import is

that Congress intended Section 959(b) to be applicable to trustees even where the property at issue was to be abandoned. Since abandonment of property is a key power of chapter 7 trustees, it is apparent that Congress intended for Section 959(b) to apply to chapter 7 trustees even in liquidating cases.

Second, 28 U.S.C. § 959(a), which was enacted along with Section 959(b), provides that a trustee may be sued for "transactions in carrying on business connected with such property." Clearly, the term "carrying on business" contemplates an operating estate that is continuing the pre-petition business of the debtor. Conversely, "manage and operate property in his possession," which is the terminology used in Section 959(b), makes no reference to carrying on a business operation. The use of these disparate terms for the two statutes supports the notion that Congress did not intend to limit the applicability of Section 959(b) to non-liquidating estates.

Third, the Supreme Court has held that 28 U.S.C. § 960(a), which provides that officers who are "conducting any business" under court authority are subject to all taxes, applies to liquidating trustees. Until the Supreme Court heard the matter, the lower courts were split on the issue in a manner similar to the split of authority relating to Section 959(b). Some courts held that "conducting any business" meant that the statute did not apply to chapter 7 liquidating trustees. The Supreme Court quashed that argument in *California Equalization Board v. Sierra Summit, Inc.* 490 U.S. 844 (1989), holding that the statute applied to liquidating trustees.

Since Section 959(b) clearly defines the property subject to application of the statute by reference to whether such property is in the trustee's possession, the records at issue clearly are in the Trustee's possession such that the Trustee must comply with applicable state laws. The Trustee has managed the storage of the records since the case was filed and cannot now abdicate that obligation without compliance with state law.

With respect to the operative date for determining "the State in which such property is situated," the date the Trustee was appointed is clearly the operative date in this case. While the Trustee decided to move the records to a centralized location in Indianapolis, Indiana, this effort should not affect the state law applicable to the retention of such records.

## I. BACKGROUND

On September 16, 2016 (the "Petition Date"), ITT Educational Services, Inc., ESI Service Corp., and Daniel Webster College, Inc. (collectively, "ITT") filed voluntary petitions for relief under chapter 7 of the Bankruptcy Code. Deborah Caruso ("Trustee") was thereafter appointed chapter 7 trustee of the ITT bankruptcy estates. Shortly prior to the Petition Date, on September 6, 2016, ITT announced the closure of all 136 of its campuses spread across the nation. ITT had been operating since 1969 as a for-profit provider of post-secondary education and enrolled hundreds of thousands of students prior to its closure. As a result of its longevity and large enrollment, a significant amount of records regarding students' academic, financial aid, tuition payments and other information (collectively, (the "Student Records")[1] accumulated over the course of ITT's existence. These records were stored on or near each ITT campus. At the direction of the Trustee, the Student Records were transferred to a centralized repository in Indianapolis, Indiana by Tiger Capital Group, LLC. The Trustee filed the Motion to establish procedures and a fee schedule for state agencies and students to obtain access to the Student Records.

[1] The Student Records currently stored by the Trustee include academic records of student' attendance, progress, or grades while attending ITT, academic history prior to students' enrollment at ITT, financial aid records and tuition payment records. The relevant State Statutes discussed below contemplate protection of students' academic records derived from enrollment at ITT, not simply all documents in students' files. Westchester reserves all rights to assert any limitation to coverage under the bonds issued by Westchester on behalf of ITT, including the status of any and all of the Student Records as documents outside the scope of any and all relevant State Statutes.

States have prioritized the protection of student academic records when a post-secondary education institution closes. Many states have enacted statutes specifically imposing duties on post-secondary education institutions in the event of their closure. A subset of these states have enacted statutes requiring the storage and/or delivery of student academic records by a corporate officer following the institution's closure. *See, e.g.*, Ga. Code Ann. § 20-3-250.17; Kan. Stat. Ann. § 74-32,175(a); Ind. Code Ann. § 21-18.5-6-10(c); Colo. Rev. Stat. Ann. § 12-59-119; Ala. Code § 16-46-3(f); Nev. Rev. Stat. Ann. § 394.550 (the examples listed are illustrative, any state statute related to the Trustee's obligations concerning the Student Records is referred to collectively as the "State Statutes"). The exact composition and duties imposed by each State Statute differ as some establish a general duty to deliver the records upon closing while others prescribe a specific deadline for delivery of the records. *Compare* Ga. Code Ann. § 20-3-250.17 (delivery upon closure) *with* Mo. Code State Reg. § 10-5.010(8)(D) (requiring delivery within 14 days of institution's closure); *and* Alaska Administrative Code § 20-17.110(c) (requiring delivery within 30 days of institution's closure). The policy goal underlying the State Statutes is ensuring that students will have access to their academic records, which is a necessity for the transfer of credits to another post-secondary institution. *See, e.g.*, Ga. Code Ann. § 20-3-250.17 (requiring as records to be filed, "at a minimum, such information as is customarily required by colleges or other postsecondary educational institutions when considering students for transfer or advanced study and, as a separate document, the academic record of each former student"). As part of their regulatory regime, some states require the institutions regulated by the relevant State Statutes to obtain a surety bond issued for the benefit of the state and/or the institutions' students for the primary purpose of reimbursing students where tuition was paid but academic courses were not

provided. *E.g.*, Ga. Code Ann. § 20-3-250.10; Nev. Rev. Stat. Ann. § 394.480; Colo. Rev. Stat. Ann. § 12-59-115.

Westchester issued numerous surety bonds (the "Bonds") on behalf of ITT related to certain obligations of ITT under applicable state law. The aggregate penal limit of the Bonds is approximately $19,787,495.19. The Bonds were issued to assure ITT's compliance with certain state regulations relating to the operation of a private post-secondary educational institution.

Following the Trustee's Motion and subsequent hearings and filings by the Trustee, various states and Westchester, the Court entered the Briefing Order. The Briefing Order requests that the parties analyze whether 28 U.S.C. § 959(b) is generally applicable to the Trustee while focusing the meaning of the phrase "manage and operate" as used in 28 U.S.C. § 959(b). It also requests that the parties analyze which state's law is applicable, provide the Court with copies of the relevant statute(s) and designate the operative date for the "State in which such property is situated" under 28 U.S.C. § 959(b).

## II. ARGUMENT

Westchester will follow the Court's outline in the Briefing Order by first illustrating why the phrase "manage and operate" easily encompasses the actions of liquidating trustees generally and the actions taken by the Trustee to transfer and store ITT's Student Records. Westchester will then canvas the broad public policy support for applying 28 U.S.C. § 959(b) to liquidating trustees, including the Trustee in this case. Finally, Westchester will address the appropriate date for determining the "State in which such property is situated" for purposes of 28 U.S.C. § 959(b). As noted above, in light of Westchester's contingent interest in this matter, Westchester will defer to each individual state to assert which state laws are applicable to this matter.

A. **The Language of 28 U.S.C. § 959(b) Supports the Conclusion that 28 U.S.C. § 959(b) Applies to Liquidating Trustees**

The plain language of 28 U.S.C. § 959(b) suggests that the Trustee was and is required to comply with applicable state laws regarding the transfer and maintenance of the Student Records. Specifically, 28 U.S.C. §959(b) provides:

> Except as provided in section 1166 of title 11, a trustee, receiver or manager appointed in any case pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

The following components of 28 U.S.C. § 959(b) are very relevant to the issues before the Court: (1) "Except as provided in section 1166 of title 11", (2) "manage and operate", and (3) "the property in his possession."

1. **The Carve-Out for Trustees in Railroad Cases, Which Expressly Addresses Abandonment, Shows that Congress Expected 28 U.S.C. § 959 to Apply to Trustees Even with Respect to Property to be Abandoned**

In the first phrase of 28 U.S.C. § 959(b), Congress carved out from the application of the subsection trustees in railroad reorganization cases by making the statute inapplicable to trustees who are subject to 11 U.S.C. § 1166. Section 1166 of the Bankruptcy Code is a sister provision to 28 U.S.C. § 959 in that it subjects trustees in railroad cases to applicable non-bankruptcy laws relating to railroads. Specifically, Section 1166 provides:

> Except with respect to abandonment under section 1170 of this title, or merger, modification of the financial structure of the debtor, or issuance or sale of securities under a plan, the trustee and the debtor are subject to the provisions of subtitle IV of title 49 that are applicable to railroads, and the trustee is subject to orders of any Federal, State, or local regulatory body to the same extent as the debtor would be if a petition commencing the case under this chapter had not been filed, but—

> (1) any such order that would require the expenditure, or the incurring of an obligation for the expenditure, of money from the estate is not effective unless approved by the court; and
>
> (2) the provisions of this chapter are subject to section 601(b) of the Regional Rail Reorganization Act of 1973.

Notably, as evident in the first sentence, Congress saw fit to expressly carve out from the application of Section 1166 the abandonment of railroads pursuant to Section 1170, while it did not expressly carve out abandonment of assets under Section 554 from the application of 28 U.S.C. § 959(b). Had Congress intended to absolve liquidating trustees of the obligation to comply with applicable state laws when abandoning property of the estate, it would have done so expressly, just as it did with respect to trustees in railroad cases. By not expressly carving out property to be abandoned by a trustee under 11 U.S.C. § 554, it is apparent that Congress intended that, pursuant to 28 U.S.C. § 959 and except in railroad cases, trustees are required to comply with applicable state laws even with respect to property that the trustees intend to abandon.

In the context of the issues before the Court, there is no distinction between abandonment and liquidation. A chapter 7 bankruptcy estate cannot be closed unless all property is either liquidated or abandoned. In the case of student records, the records cannot be feasibly sold due to privacy laws and the simple fact is that they generally have no value to anyone other than the particular student. Consequently, liquidation of a post-secondary educational institution will in every case require the Trustee to abandon the estate's interest in the records at some point. Based on Congress's decision not to expressly exempt chapter 7 trustees from 28 U.S.C. § 959(b) with respect to property to be abandoned, then 28 U.S.C. § 959(b) requires the Trustee in this case to comply with applicable state laws relating to the records.

**2. Congress's Use of the Phrase "Manage and Operate the Property" Indicates an Intent that Liquidating Trustees Must Comply with Applicable State Law.**

The second notable component of 28 U.S.C. § 959(b) is the phrase "manage and operate." The Trustee has argued that this phrase means that the provisions of 28 U.S.C. § 959(b) do not apply to liquidating trustees because they do not operate a debtor's assets. This interpretation does not follow how Congress has distinguished operating cases from liquidating cases in other statutes. Notably, Congress did not use the phrase "carrying on business connected with such property" or "conducting any business", which is the phraseology used in 28 U.S.C. §§ 959(a) and 960(a), respectively. An analysis of each of these statutes sheds light on how this Court should interpret the term "manage and operate" to be consistent with Congressional intent.

**(a) Analysis of Section 28 U.S.C. § 959(a)**

Section 959(a) provides that "Trustees . . . of any property . . . may be sued . . . with respect to any of their acts and transactions in carrying on business connected with such property." If the Trustee was correct that the term "manage and operate" means only cases where a trustee continues to carry on business operations of a debtor, then why didn't Congress employ the same phraseology used in 28 U.S.C. § 959(a)? Clearly, by the separate use of the terms "carrying on business connected with such property" and "manage and operate the property" in the same statute, Congress intended the terms to have different meanings. As is clear, the terminology used in 28 U.S.C. § 959(a) focuses on the Trustee's operation of the business related to the property, while the terminology used in 28 U.S.C. § 959(b) focuses on the Trustee's management of the property itself, without regard to the operation of the business.

Congress' choice of "carrying on business" rather than "operate and manage" in 28 U.S.C. § 959(a) signals that liquidating and administering property in a trustee's possession must be

conducted pursuant to state law. Section 959(a) is an exception to the *Barton Rule*[2] that allows estate representatives to be sued without leave of the appointing court concerning "acts or transactions in carrying on business connected with such property." The phrase "carrying on business connected with such property" clearly contemplates the continued operations related to the property. In contrast, liquidation is not "carrying on business connected with such property;" it is ending the business. As a result, courts have not applied the exception in 28 U.S.C. § 959(a) to liquidating trustees. *E.g.*, *Allard v. Weitzman (In re Delorean Motor Co.)*, 991 F.2d 1236, 1241 (preserving, administering or liquidating estate is not carrying on business and 28 U.S.C. § 959(a) is not applicable); *In re Kalb & Berger Mfg.*, 165 F. 895, 896-97 (2nd Cir. 1908) (same). If Congress had wanted to limit the reach of 28 U.S.C. § 959(b) to operating trustees, it could have either solely used the word "operate" or copied the language from 28 U.S.C. § 959(a). It did neither and its failure to choose either of these options further supports that 28 U.S.C. § 959(b) is applicable to liquidating trustees.[3]

**(b) Analysis of 28 U.S.C. § 960(a)**

Similarly, Congress's use of differing terminology in 28 U.S.C. § 960(a) and the Supreme Court's interpretation of the same is instructive. Section 960(a) provides:

> Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.

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[2] The *Barton Rule* "mandates that a plaintiff who wishes to bring an action against the receiver outside of the receivership court must first obtain permission of the receivership court, which should not be granted absent a prima facie showing to the receivership court of the merits of the claim." *In re DMW Marine, LLC*, 509 B.R. 497, 503 (E.D. Pa. 2014).

[3] Courts who have cited 28 U.S.C. § 959(a) in support of excepting liquidating trustees from 28 U.S.C. § 959(b) have roundly failed to consider this conclusion and instead have lumped the two provisions together. *See Walker v. Maury Cnty (In re Scott Housing Sys., Inc.)*, 91 B.R. 190, 196 (Bankr. S.D. Ga. 1988).

The phrase "conducting any business" used in 28 U.S.C. § 960(a) was subject to a split among courts paralleling the current split regarding 28 U.S.C. § 959(b) – some courts read 28 U.S.C. § 960(a) as applying to all trustees while others excepted liquidating trustees. The Supreme Court saw no reason why liquidating trustees should be excepted under the language of the statute and required the liquidating trustee to satisfy the duties imposed by 28 U.S.C. § 960(a). *Cal. Equalization Bd. v. Sierra Summit, Inc.* 490 U.S. 844 (1989). The same result applies to Trustee in this case under 28 U.S.C. § 959(b).

The erroneous view that "manage and operate" as used in 28 U.S.C. § 959(b) does not apply to liquidating trustees originated from the Supreme Court's description of the predecessor to 28 U.S.C. § 959(b) in *Palmer v. Webster & Atlas Nat'l Bank of Boston*, 312 U.S. 156 (1941). In *Palmer*, an operating trustee of the New York, New Haven and Hartford Railroad Company was in possession of property of another railroad, Old Colony Railroad Company, pursuant to a lease under which the debtor was required pay taxes and bond interest related to the leased properties under a Massachusetts statute. *Id.* at 157. The trustee declined to pay the bond interest accruing after he rejected the lease and the counterparty to the bond sought to compel payment pursuant to 28 U.S.C. § 125, the predecessor to 28 U.S.C. § 959(b). The Supreme Court did not compel the trustee's payment because the lease had been rejected. *Id.* at 167. In the process of making this ruling, the Court described that 28 U.S.C. § 125's

> obvious purpose was to negative the idea that a federal receiver or trustee could ignore the rules of law of the state of operation affecting the conduct of the business committed to his charge. In this sense it has been interpreted and applied and, in this sense, it is certainly binding upon the trustees of New Haven so long as they operate the property of the former lessors.

*Id.* To clarify, the Court in *Palmer* analyzed the actions of a trustee operating a reorganizing debtor, where no hint of liquidation was present. The use of term "operate" was merely descriptive

of the current state of facts for that case, not a blanket statement that non-operating estates did not have to comply. Nonetheless, courts latched onto the above-quoted language from *Palmer* and excepted liquidating trustees from satisfying 28 U.S.C. § 959(b). *See, e.g., In re Corona Plastics, Inc.*, 99 B.R. 231, 236 (Bankr. D.N.J. 1989); *In re Borne Chem. Co., Inc.*, 54 B.R. 126, 135 (Bankr. D.N.J. 1984). These early cases under the Bankruptcy Code and 28 U.S.C. § 959(b) created momentum that lead to later courts simply reciting this view with little or no analysis. *E.g., In re St. Lawrence Corp.*, 239 B.R. 720, 726 (Bankr. D.N.J. 1999); *Ala. Surface Mining Comm'n v. N.P. Mining Co., Inc. (In re N.P. Min. Co., Inc.)*, 963 F.2d 1449, 1461 (11th Cir. 1992). Following this path might be a reasonable choice if *Palmer* had analyzed liquidating trustees at all. It didn't and this Court should not follow the mistakes of other courts in blindly relying upon it.

Instead of the *Palmer* opinion, the Court should look to the Supreme Court's resolution of the parallel split regarding 28 U.S.C. § 960(a) in *California Equalization Board v. Sierra Summit, Inc.* 490 U.S. 844 (1989), for guidance in interpreting 28 U.S.C. § 959(b). Section 960(a) serves a similar, if more limited, purpose than 28 U.S.C. § 959(b), as it provides that an estate representative "conducting any business under authority of a United States Court" is subject to all applicable federal, state, and local taxes. Prior to the Supreme Court's holding in *Sierra Summit*, courts were split on whether liquidating trustees were required to comply with 28 U.S.C. § 959(a) and pay state taxes. Some courts relied upon both the language of the statute as well as public policy to except liquidating trustees from paying applicable taxes. The statutory language argument was based on the assertion that liquidating trustees were not "conducting any business." *E.g. Great Am. Bank of Broward Cnty v. McCracken (In re Cusato Bros. Int'l, Inc.)*, 750 F.2d 887, 891 (11th Cir. 1985); *In re Samoset Assocs.*, 14 B.R. 408, 414 (Bankr. D. Me. 1981). The policy argument against imposing state taxes on a liquidating trustee was that it "would be an

impermissible burden upon the liquidation process." *Cusato Bros.*, 750 F.2d at 890; *Cal. State Bd of Equalization v. Goggin*, 245 F.2d 44 (9th Cir. 1957), *cert. denied*, 353 U.S. 961 (1957). Other courts were unpersuaded by these arguments. These courts determined that the language of 28 U.S.C. § 960(a) (and its predecessor) was not a clear articulation of an exemption for trustees from applicable taxes and such taxes were not an impermissible burden on the liquidating duties of the trustees. *Blackmon v. Nichols (In re Hatfield Const. Co.)*, 494 F.2d 1179, 1181 (5th Cir. 1974); *Missouri v. Gleick*, 135 F.2d 134, 137 (8th Cir. 1943).

In *California State Board of Equalization v. Sierra Summit, Inc.*, the Supreme Court explained that both the statute and the policy did not support an exception for a liquidating trustee. 490 U.S. 844, 852 (1989). The Court clarified that only a clear indication from Congress could exempt a liquidating trustee from state taxes. *Id.* 851-52. The term "conducting any business" did not constitute a sufficiently clear indication necessary to support an exception for liquidating trustees. Rather, "[r]ead most naturally, the statute evinces an intention that a State be permitted to tax a bankruptcy estate notwithstanding any intergovernmental immunity objection that might be interposed." *Id.* at 852. In dismissing the policy argument, the Court relied upon earlier statements supporting the broad application of state law to property in the hands of a trustee:

> By the transfer to the trustee no mysterious or peculiar ownership or qualities are given to the property, and that there is nothing in that to withdraw it from the necessity of protection by the State and municipality, or which should exempt it from its obligations to either. If Congress wished to declare otherwise, its intent would have to clearly expressed, not left to be collected or inferred from disputable considerations of convenience in administering the estate of the bankrupt.

*Id.* at 853-54 (quoting *Swarts v. Hammer*, 194 U.S. 441 (1904)) (internal quotations omitted).

The parallels between 28 U.S.C. § 959(b) and 28 U.S.C. § 960(a) and the Supreme Court's application of 28 U.S.C. § 960(a) to liquidating trustees in *California State Board of Equalization* should guide this Court's interpretation of "manage and operate property." Just like the term

"conducting any business" in 28 U.S.C. § 960, "manage and operate property" is not a clear indication that Congress wanted to except liquidating trustees from satisfying relevant state law. Moreover, the possession by the trustee does not eliminate the trustee's duty to satisfy state law as nothing mysterious or peculiar occurs – the trustee merely accedes to possession from the debtor. Clear Congressional expression is required but does not exist. An inference by its very nature is not a clear expression. The inference that it is convenient to liquidate and administer property without having to satisfy state law does not support an exemption for liquidating trustees.

The broad words chosen – "manage and operate the property" – evidence that Congress intended to require all trustees to comply with state laws applicable to property in the possession of the trustee. In spite of its long history, the phrase "managing and operating the property" has not been defined by statute or the Supreme Court. Congress first enacted this requirement in 1887 when it required that federal receivers and managers "in possession of any property shall manage and operate such property according to the requirements of the valid laws of the State in which such property shall be situated in the same manner the owner or possessor thereof would be found to do if in possession thereof." 24 U.S.C. § 554(2). The statute was amended slightly in 1911 and 1948 prior to the latest amendments in 1978 to conform its language to the Bankruptcy Code. *See The Briarcliff v. The Briarcliff Tenants Assoc. (In re The Briarcliff)*, 15 B.R. 864, 866-67 (D.N.J. 1981) (quoting predecessors of 28 U.S.C. § 959(b) and comparing to current version). At no time has the phrase "manage and operate property" been defined and no legislative history exists guiding the interpretation of this phrase. *City of New York v. Quanta Res. Corp. (In re Quanta Res. Corp.)*, 739 F.2d 912, 919 (3d Cir. 1984), *aff'd sub nom. Midlantic*, 474 U.S. 494.

The plain language of the words "manage" and "operate" suggests a broad meaning. Courts first analyze the plain language of a statute in an effort to parse its meaning. *United States*

*v. Ron Pair Enters.*, Inc., 489 U.S. 235, 241 (1989). The plain meaning of ordinary words is derived from the words' dictionary definitions. *F.D.I.C. v. Meyer*, 510 U.S. 471, 476 (1994). The dictionary definition of "manage" is "to handle or direct with a degree of skill." *See* https://www.merriam-webster.com/dictionary/manage.[4] The dictionary definition of operate is "to cause to function." https://www.merriam-webster.com/dictionary/operate. Section 959(b) uses the conjunctive "and" to impose the requirement that a trustee both manage and operate the property in the trustee's possession. Combining the plain language and dictionary definitions, 28 U.S.C. § 959(b) requires a trustee to follow the requirements of applicable state when both (i) handling and directing the property in the trustee's possession with a decree of skill and (ii) causing the same property to function.

The use of two requirements – manage and operate – signals that Congress did not want to only require trustees to satisfy state law when operating property. Courts construe language in order to give effect all provisions "so that no part will be inoperative or superfluous, void or insignificant." *Corley v. United States*, 556 U.S. 303, 314, 129 (2009). In considering the two terms manage and operate, they should be construed as having different meanings in order to evade making either term superfluous. The difference between handling or directing property compared to causing the property to function reflects the differences between the two terms and leaves neither as surplusage. Moreover, the use of the two different terms reflects that the Congressional goal of requiring a trustee to satisfy state laws not only when operating the debtor's property but also when handling or directing it. The former will be implicated by an operating trustee while the latter will be implicated by both operating and liquidating trustees.

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[4] Both "manage" and "operate" are used as transitive verbs in 28 U.S.C. § 959(b) and the definitions quoted in this paragraph reflect this categorization.

Based on Congress's use of the differing terminology in Sections 959(a) and 959(b), and the broad defined meaning of "manage and operate," Congress clearly intended that trustees, even in liquidating cases, are required to manage the property in accordance with applicable state laws. Accordingly, the Trustee is not exempt from compliance with the state laws applicable to the handling of student records.

**3. By Defining Property Subject to 28 U.S.C. § 959(b) by Reference to Possession by the Trustee, Rather than Relationship to Business Operation, Congress Has Indicated Its Intent that 28 U.S.C. § 959(b) Apply Regardless of the Operating Status of the Case.**

The third notable component of 28 U.S.C. § 959(b) is that the property subject to 28 U.S.C. § 959(b) is defined as "property in [the Trustee's] possession," not by the role of the property in the business operation. This is significant because, in many cases, the restructuring of a debtor will contemplate shutting down certain business operations while continuing to operate others. Thus, classifying a case as wholly a liquidation or wholly a reorganization is not possible. Almost every chapter 11 case incorporates the liquidation of assets along with the continuation of other aspects of the business. Retail stores in bankruptcy often have "liquidation sales" during which the debtor acquires additional inventory for the purpose of enhancing the sale. Although the sale is technically a liquidation, there is a business operation that is part of the process. By defining the Trustee's obligation under 28 U.S.C. § 959(b) by reference to "property in his possession," Congress recognized that defining property as operating or liquidating is simply not possible in most bankruptcy cases. Congress chose to define the property as either in the possession of the Trustee or not in the Trustee's possession. Since the Student Records are in the Trustee's possession, the Trustee is subject to 28 U.S.C. § 959(b) and State Statutes when managing with such property.

The Trustee's transfer, storage and maintenance of the Student Records constitutes managing of ITT's property in her possession. The Trustee directed the transfer of the Student Records (ITT's property within the Trustee's possession) from ITT's disparate campuses to a centralized repository pursuant to her agreement with Tiger Capital Group, LLC. The Trustee further requested the relief in the Motion to include approval of procedures for accessing the Student Records and the costs incident to such access. The plain language of 28 U.S.C. § 959(b) governs the actions already taken by the Trustee and the relief sought in the Motion. She must satisfy the applicable State Statutes in order to fulfill her duties under 28 U.S.C. § 959(b).

The Trustee asserts her management of the Student Records is not regulated by the relevant State Statues because she is not an officer of ITT or an operator of ITT. The Trustee's arguments ignore her status as successor to ITT and her management of its property in her possession. The requirement of some State Statutes to deliver the records functionally requires an agent/employee of ITT to deliver the relevant records to the regulator. Once a chapter 7 trustee is appointed, debtor's prior management is "completely ousted" and the trustee steps into the shoes of the officers and/or directors to manage the debtor's estate. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 352-53 (1985). Upon ITT's bankruptcy filing, its management, including any officer required to deliver records, were ousted. The Trustee stepped into the shoes of ITT's management and assumed the duty to deliver Student Records. The Trustee's actions in managing the Student Records further illustrate her status as the successor in interest to ITT, including the duties it owed concerning the Student Records.

**B. <u>The Trustee Is Required to Satisfy the State Statutes to Protect Public Welfare</u>**

When a liquidating trustee's management of property contravenes state public health, safety, or welfare regulations, the trustee violates 28 U.S.C. § 959(b). The protections for state

law expressed in the Bankruptcy Code and recognized by the Supreme Court illustrate that "Congress did not intend for the Bankruptcy Code to pre-empt all state laws that otherwise constrain the exercise of a trustee's powers." *Midlantic Nat. Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494, 505 (1986). The exception to the automatic stay for state police power illustrates this policy. Although the automatic stay is a fundamental protection for the estate, one of the enumerated exceptions allows governments (including states) to enforce non-monetary judgments against the estate pursuant to their police and regulatory authority. 11 U.S.C. § 362(b)(4);[5] *Midlantic*, 474 U.S. at 502 ("Congress has expressly provided that the trustee's efforts to marshal and distribute the estate's assets must yield to governmental interests in public health and safety."). The policy supporting this exception is the need to "prevent or stop violation of fraud, environmental, consumer protection, safety or similar policy or regulatory laws." *Midlantic Nat. Bank*, 474 U.S. at 502 (quoting S. Rep. No. 95–989, p. 54 (1978); H.R. Rep. No. 95–595, p. 340 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5787, 5840, 5963, 6296) (emphasis omitted). In the context of environmental regulations, the Supreme Court has spoken in broad terms of chapter 7 trustees' duties to comply with applicable state law. *Midlantic*, 474 U.S. at 502; *Ohio v. Kovacs*, 469 U.S. 274, 285 (1985) ("we do not question that anyone in possession of the site [including] the bankruptcy trustee - must comply with the environmental laws of the State of Ohio. Plainly, that person or firm may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions.") (emphasis added). Indeed, the Supreme Court relied upon 28 U.S.C. § 959(b) as support for requiring a chapter 7 trustee to satisfy environmental obligations prior to abandonment. *Midlantic*, 474 U.S. at 505.

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[5] This is distinguished from a state's attempts to collect on a claim based on its pecuniary interests. *In re Benalcazar*, 283 B.R. 514, 530 (Bankr. N.D. Ill. 2002)

The goal of protecting public health, safety, and welfare is not diminished when a trustee controls a liquidation compared to operating entity. It is a distinction without a difference. *City of New York v. Quanta Res. Corp. (In re Quanta Res. Corp.)*, 739 F.2d 912, 919 (3d Cir. 1984) ("there is no reason to suppose Section 959(b) inapplicable in chapter 7"), *aff'd sub nom. Midlantic*, 474 U.S. 494. In *Lancaster v. Tennessee (In re Wall Tube & Metal Products Co.)*, the Sixth Circuit recognized this common-sense conclusion in applying 28 U.S.C. § 959(b) to liquidating trustees. 831 F.2d 118 (6th Cir. 1987). *Wall* involved a liquidating chapter 7 trustee's attempts to evade a Tennessee's environmental statute and any associated administrative expense claim by the State of Tennessee. The chapter 7 trustee asserted that 28 U.S.C. § 959(b) was not applicable to liquidating trustees. The Sixth Circuit dismissed the trustee's argument based upon the inconsequential distinction between a liquidating and an organizing trustee "in the critical context of the public's welfare. In either case, an environmental hazard on the estate's property is within the control of the trustee." *Id.* 122. Replace "environmental hazard" with "student records" and these are the facts of this case. The same result should apply.

The potential problems that could arise by distinguishing between liquidating and operating trustees is even more obvious in *Texas v. Lowe (In re H.L.S. Energy Co., Inc.)*, 151 F.3d 434 (5th Cir. 1998). In *H.L.S.* a chapter 11 trustee operated a debtor post-petition and after the debtor's valuable assets were sold, the case was converted to chapter 7. *Id.* at 436. During the chapter 11, Texas regulators attempted to enforce Texas state laws requiring the plugging of unproductive wells. After conversion, the Texas regulators eventually plugged the wells to satisfy the debtors' statutory obligations and filed claims for administrative expenses against the estate based on the cost of plugging. *Id.* The Fifth Circuit did not allow the chapter 7 trustee to evade these claims because he was required to plug unproductive wells pursuant to Texas law related to public safety

and welfare under 28 U.S.C. § 959(b). *Id.* at 938. If the rule were otherwise it would promote extreme gamesmanship. It would incentivize a failure to satisfy state law in chapter 11 followed by a conversion of the case to a liquidating chapter 7 where the trustee would not need to satisfy the state law. The state would be left holding the bag while public welfare is not served. The same effect can occur in a chapter 7 case – the middle step of a chapter 11 trustee is eliminated. A liquidating trustee simply must comply with applicable public health, safety and welfare laws. *See, e.g., United States Sec. & Exch. Comm'n v. Harris*, No. 3:09-CV-1809-B, 2016 WL 1555773, at *8 (N.D. Tex. Apr. 18, 2016) (federal receiver was required to satisfy New Mexico state law plugging obligations); *Lawson v. Town of Sardinia (In re Chaffee Aggregates, Inc.)*, 300 B.R. 170, 173 (Bankr. W.D.N.Y. 2003) (chapter 7 trustee must comply with zoning ordinance).

Public welfare statutes are just as befitting of enforcement as environmental statutes. Indeed, the Bankruptcy Court for the District of New Jersey required a chapter 7 trustee to satisfy the New Jersey Structured Protection Act (undoubtedly a public welfare statute) when selling an annuity pursuant to 28 U.S.C. § 959(b). *In re Jackus*, 442 B.R. 365, 369-70 (Bankr D.N.J. 2011). The State Statutes in this matter are public welfare statutes enacted to protect students' ability to transfer their credits and continue their education following the closure of the post-secondary institution. Accordingly, the Court should hold that the Trustee is required to comply with the state statutes applicable to the student records.

### C. The Operative Date for determining "the State in which Such Property Is Located" is the Date of Appointment of the Initial Trustee

Section 959(b) requires the management and operation of property in the possession of the trustee to satisfy the state law "of the State in which such property is situated." Westchester asserts that the determination of the applicable state law is something that would need to be determined

on a case by case basis. Clearly, the rights and duties of a chapter 7 trustee, including possession of the debtor's property, vest upon the trustee's appointment. See 11 U.S.C. § 701(c). As a result, the trustee possesses property in her capacity as a trustee as soon as she is appointed. Section 959(b) states that the duty to satisfy state law regulating the property is triggered by a trustee's possession. Therefore, a trustee is bound to comply with 28 U.S.C. § 959(b) immediately after being vested with possession of the debtor's property by her appointment. It follows then that a trustee is bound to comply with the laws of the state in which such property resides on such appointment date. To allow a trustee to forum shop by moving property from one jurisdiction to another would allow a trustee to potentially defeat the violations of the underlying state statute.

However, the transfer of property between jurisdictions may, in certain cases, require a trustee to comply with the laws of the jurisdiction to which the property was transferred, in addition to the laws of the jurisdiction where the property was initially situated. For example, if the Trustee was in possession of a tanker truck that was in Wisconsin on the date of the trustee's appointment but was subsequently driven to Florida, Section 959(b) should be interpreted to require the trustee's compliance with Florida law while not exempting the trustee from having potentially violated Wisconsin law. In this case, however, the Trustee's transfer of the Student Records to a central repository likely does not subject her to the laws of the State of Indiana with respect to the transferred records because, upon information and belief, Indiana does not have laws addressing the non-Indiana records of post-secondary educational institutions. Accordingly, the Trustee should be required, at a minimum, to comply with the state laws applicable to the records where such records resided as of the date of the Trustee's appointment.

## CONCLUSION

Based on the foregoing, Westchester respectfully requests that the Court hold that, pursuant to 11 U.S.C. § 959(b), the Trustee is subject to compliance with all applicable state laws regarding the maintenance and disposition of the student records in her possession based on the state in which such records were maintained as of the date the Trustee was appointed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served upon all persons registered to receive ECF notice in this chapter 7 case through this Court's CM/ECF System.

/s/ Edward M. King
Edward M. King

TMP.TMP 4846-4632-7626v2

AMERICAN BANKRUPTCY INSTITUTE 2021 ANNUAL SPRING MEETING

# CONCERNS SPECIFIC TO NON-PROFIT DEBTORS

AMERICAN BANKRUPTCY INSTITUTE 2021 ANNUAL SPRING MEETING

# NON-PROFIT DEBTORS

**Bankruptcy Code Provisions Dealing with Non-Profits:**

- The 2005 amendments to the Bankruptcy Code brought provisions expressly requiring that that sale of not-for-profit entities be in accordance with applicable non-bankruptcy law. There are very few reported decisions dealing with these provisions, but they can impose a great burden on the sale of healthcare provider's assets in bankruptcy.
- 11 U.S.C. §363(d): "The trustee may use, sell, or lease property … (1) in the case of a debtor that is a [nonprofit] corporation or trust … only in accordance with nonbankruptcy law applicable to the transfer of property by a debtor that is such a corporation or trust; and (2) only to the extent not inconsistent with any relief granted under subsection (c), (d), (e), or (f) of section 362."
- 11 U.S.C. §541(f): Notwithstanding any other provision of this title, property that is held by a debtor that is a [nonprofit] corporation … may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the debtor had not filed a case under this title.
- 11 U.S.C. §§ 1129(a)(16), 1221(d), 1221(e)

**Non-Profit Sale Considerations:**

- 11 U.S.C. §363(d) has two implications: (1) debtors and courts considering the sale of not-for-profit hospitals can consider charitable mission when selecting the "best" offer for assets, *In re United Healthcare Sys., Inc.* 1997 U.S. Dist. LEXIS 5090 (Mar. 26, 1997); and (2) debtors and courts must consider implications of state law when selling not-for-profit assets, *In re Gardens Regional Hospital and Medical Center, Inc.*, 567 B.R. 820 (Bankr. C.D. Cal. 2017).
- State law non-profit issues particularly relevant in California due to attorney general review of the sale of non-profit hospitals:
- Cal. Corp. Code §§5914-5919 provide that the sale or other transactions of or by nonprofit healthcare entities to (i) for profit entities, (ii) nonprofit entities, and (iii) community benefit entities, are subject to review (but does not include transactions with governmental entities).
- The review process requires submission of an application and lengthy documents, and includes retention of an expert, at the hospital's expense, as well as a public meeting. In bankruptcy cases, application submitted after entry of the sale order; Parties are encouraged to submit statements and the expert will interview stakeholders; the Attorney General has 90 days to conduct the review (can be extended for 45 more days); the Attorney General can approve or disapprove the transaction, or approve with conditions.
- *Verity Health* – §363(f) may cut off certain AG conditions as "interests in property"

**Non-Profit Board Considerations in Bankruptcy**

- Nonprofit boards in bankruptcy have two duties with regard to reviewing bids for assets:
  - The first duty, imposed by state law, is their charitable mission to provide healthcare.

- The second duty, imposed as part of their obligations as debtors in possession in a bankruptcy case, is to maximize the recovery for their creditors.
- In this context, boards must pick the "highest and best" bid by balancing those obligations.

**Bankruptcy Code Provisions that Exclude Non-Profits:**

- Section 303 of the Bankruptcy Code allows creditors to involuntarily commence a bankruptcy case against a potential debtor but that right does not exist against a nonprofit entity.
- Section 1112 provides that a chapter 11 case may be converted involuntarily to a liquidation under chapter 7, but that does not apply to a nonprofit entity.

KeyCite Red Flag - Severe Negative Treatment
Judgment Vacated by In re Verity Health System of California, Inc., Bankr.C.D.Cal., November 13, 2019

2019 WL 5585007

Only the Westlaw citation is currently available.
United States Bankruptcy Court, C.D. California,
Los Angeles Division.

IN RE: VERITY HEALTH SYSTEM OF CALIFORNIA, INC., et al.,
Debtors and Debtors in Possession.
#Affects All Debtors

Lead Case No.: 2:18-bk-20151-ER

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Jointly Administered With: Case No. 2:18-bk-20162-ER; Case No. 2:18-bk-20163-ER; Case No. 2:18-bk-20164-ER; Case No. 2:18-bk-20165-ER; Case No. 2:18-bk-20167-ER; Case No. 2:18-bk-20168-ER; Case No. 2:18-bk-20169-ER; Case No. 2:18-bk-20171-ER; Case No. 2:18-bk-20172-ER; Case No. 2:18-bk-20173-ER; Case No. 2:18-bk-20175-ER; Case No. 2:18-bk-20176-ER; Case No. 2:18-bk-20178-ER; Case No. 2:18-bk-20179-ER; Case No. 2:18-bk-20180-ER; Case No. 2:18-bk-20181-ER

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Date: October 15, 2019, Time: 10:00 a.m.,
Location: Ctrm. 1568, Roybal Federal Building, 255 East Temple Street, Los Angeles, CA 90012

|

Signed October 23, 2019

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**MEMORANDUM OF DECISION GRANTING DEBTORS' EMERGENCY MOTION TO ENFORCE THE SALE ORDER [DOC. NO. 3188]**

Ernest M. Robles, United States Bankruptcy Judge

*1 Before the Court is the Debtors' motion to sell four not-for-profit hospitals free and clear of regulatory conditions which the California Attorney General claims authority to impose under Cal. Corp. Code § 5914. For the reasons set forth below, the Court finds that § 363 of the Bankruptcy Code authorizes a sale free and clear of the conditions which the Attorney General contends he is authorized to impose.

**I. Facts**

On August 31, 2018 (the "Petition Date"), Verity Health Systems of California ("VHS") and certain of its subsidiaries (collectively, the "Debtors") filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. The Debtors' cases are being jointly administered.

As of the Petition Date, the Debtors operated six acute care hospitals in the state of California. On December 27, 2018, the Court authorized the Debtors to sell two of their hospitals —O'Connor Hospital and Saint Louise Regional Hospital— to Santa Clara County (the "Santa Clara Sale").[1] The Santa Clara Sale closed on February 28, 2019.

On February 19, 2019, the Court entered an order establishing bidding procedures (the "Bidding Procedures Order") for the auction of the Debtors' four remaining hospitals—St. Francis Medical Center ("St. Francis"), St. Vincent Medical Center (including St. Vincent Dialysis Center) ("St. Vincent"), Seton Medical Center ("Seton"), and Seton Medical Center Coastside ("Seton Coastside") (collectively, the "Hospitals"). Under the Bidding Procedures Order, Strategic Global Management ("SGM") was designated as the stalking horse bidder. SGM's bid for all four of the Hospitals was $610 million.

The Hospitals were extensively marketed by the Debtors' investment banker, Cain Brothers, a division of KeyBank Capital Markets, Inc. ("Cain Brothers"). Cain Brothers notified ninety parties of the auction process. Sixteen of these parties requested continued access to a data room containing information about the Hospitals.

 

Notwithstanding Cain Brothers' thorough marketing efforts, the Debtors did not receive any qualified bids for all of the Hospitals. The Debtors received one bid to purchase only St. Vincent and one bid to purchase only St. Francis. After consulting with the Official Committee of Unsecured Creditors (the "Committee") and the largest secured creditors, the Debtors determined not to conduct an auction. On May 2, 2019, the Court entered an order finding that SGM was the winning bidder and approving the sale to SGM (the "SGM Sale").

In 2015, prior to the commencement of these cases, the Debtors' predecessor sought authorization from the California Attorney General (the "Attorney General"), pursuant to Cal. Corp. Code § 5914, to implement a *System Restructuring and Support Agreement* (the "Restructuring Agreement"). The Attorney General approved the Restructuring Agreement, subject to various conditions (the "2015 Conditions"). Among other things, the 2015 Conditions required capital expenditures to make the Hospitals seismically compliant, and required the Hospitals to maintain specified levels of emergency services, intensive care services, cardiac services, and various other services.

***2** Cal. Corp. Code § 5914 requires a non-profit entity operating a health facility to obtain approval from the Attorney General when selling a material amount of its assets to a for-profit entity. Pursuant to Cal. Corp. Code § 5914, the Debtors submitted the SGM Sale to the Attorney General for review.

The Asset Purchase Agreement under which SGM agreed to purchase the Hospitals (the "APA") provided that SGM would close the sale so long as any conditions imposed by the Attorney General under the review process set forth in Cal. Corp. Code § 5914 were substantially consistent with conditions that SGM had agreed to accept (the "Approved Conditions").[2] In the event that the Attorney General sought to impose conditions materially different from the Approved Conditions (the "Additional Conditions"), the APA provided that the Debtors would have an opportunity to seek a determination from the Court that the Hospitals could be sold free and clear of the Additional Conditions under § 363(f) of the Bankruptcy Code. Under the APA, Additional Conditions imposing upon SGM costs of $5 million or more are conclusively deemed to be materially different from the Approved Conditions. Further, if the Debtors fail to obtain a final, non-appealable order authorizing the sale free and clear of the Additional Conditions, SGM is not obligated to close on the sale and is entitled to a refund of its good faith deposit.

On September 25, 2019, the Attorney General consented to the SGM Sale, subject to various conditions (the "2019 Conditions"). The 2019 Conditions are materially different from the Approved Conditions that SGM had agreed to accept. In particular, two of the 2019 Conditions impose an additional financial burden upon SGM of approximately $305 million. First, the 2019 Conditions require that SGM continue to operate St. Vincent as a licensed general acute care hospital through December 2024. SGM had agreed to maintain St. Vincent's general acute care license only through December 2020. SGM estimates that continuing to operate St. Vincent as a general acute care hospital for an additional four years would cost approximately $285 million. Second, the 2019 Conditions require St. Francis to provide annual charity care in an amount of $12,793,435 for six fiscal years. The required charity care amount is approximately $6.4 million more than the charity care that St. Francis provided in fiscal year 2019. The charity care requirement imposes an additional incremental cost of approximately $20 million.

SGM will not close the sale absent an order finding that the Hospitals can be sold free and clear of the Additional Conditions pursuant to § 363(f). If the SGM Sale does not close, the most likely outcome will be the closure of St. Vincent, Seton, and Seton Coastside. The Debtors would be required to close these three Hospitals to conserve resources to continue to operate St. Francis, the most solvent of the Hospitals, during the time it would take to obtain approval of a sale of St. Francis. The Debtors cannot continue to sustain operational losses of approximately $450,000 per day without the prospect of a prompt sale. There is no back-up bidder to purchase the Hospitals if the SGM Sale does not close.

***3** The Debtors are facing very significant liquidity constraints. Recently, the California Department of Health Care Services (the "DHCS") began withholding certain Medi-Cal fee-for-service payments owed to the Debtors, for the purposing of recovering alleged Medi-Cal overpayments. As of the beginning of October 2019, DHCS had withheld approximately $4.5 million. The Debtors do not have the ability to borrow under any debtor-in-possession financing facility. At this time, the Debtors' cases are being financed by a consensual cash collateral stipulation executed between the Debtors and the principal secured creditors (the "Cash Collateral Stipulation"). Termination of the APA constitutes an event of default under the Cash Collateral Stipulation.

It is unclear whether the Debtors would be able to obtain alternative financing. Further, the Debtors must begin the expensive process of closing the Hospitals while they still possess a significant cash buffer.[3] In short, the Debtors' prediction that failure of the SGM Sale would necessitate the closure of St. Vincent, Seton, and Seton Coastside is not a bluff.

The Attorney General asserts that imposition of the 2019 Conditions will not result in the closure of St. Vincent, Seton, or Seton Coastside. The Attorney General points to a declaration from Kenneth Sim, M.D. (the "Sim Decl."), the Chairman of Allied Physicians of California, A Professional Medical Corporation ("Allied"). According to the Attorney General, the Sim Decl. shows that Allied is prepared to acquire Seton and Seton Coastside and operate both Hospitals in accordance with the 2019 Conditions.

Contrary to the Attorney General's characterization, the Sim Decl. provides no certainty that a sale of Seton and Seton Coastside will occur. The Sim Decl. states only that "Allied remains interested in purchasing Seton ...." Sim Decl. at ¶ 5. The Court further notes that Allied did not timely submit a qualified bid for Seton. At this late stage in the proceedings, Allied's vague statement that it is "interested" in purchasing Seton and Seton Coastside does nothing to dissuade the Court from its conclusion that absent consummation of the SGM Sale, Seton and Seton Coastside will most likely close.

The Attorney General also points to a bid for the Hospitals submitted by Prime Healthcare ("Prime"). The Attorney General overlooks the Prime did not submit a qualified bid. Among other things, Prime failed to submit the mandatory good faith deposit. In fact, Prime itself recognized that its "bid will not be formally considered at auction" and was submitted only "for reference."[4] Further, Prime stated that it did not want to serve as a back-up bidder.[5] In short, Prime's offer to purchase the Hospitals is just as illusory as Allied's.

Finally, the Attorney General points to an offer by AHMC Healthcare, Inc. ("AHMC Healthcare") to purchase St. Francis. The Attorney General is correct that AHMC submitted a qualified bid to purchase St. Francis. However, even assuming that AHMC would follow through on its prior bid to purchase St. Francis, that still would not prevent the closure of St. Vincent, Seton, and Seton Coastside. As discussed above, the Debtors lack sufficient cash to continue operating all four Hospitals during the time it would take for a sale of St. Francis to close. The Debtors would be required to close St. Vincent, Seton, and Seton Coastside to conserve the cash necessary to operate St. Francis during the sale process.

It is against this backdrop that the Debtors move for authorization to sell the Hospitals free and clear of the Additional Conditions, pursuant to § 363(f). The Debtors argue that the Additional Conditions constitute an "interest in property" within the meaning of § 363(f), and that a sale free and clear of the 2019 Conditions may be authorized under § 363(f)(1), (4), or (5), for the following reasons:

*4 • Pursuant to § 363(f)(1), the Hospitals may be sold under applicable nonbankruptcy law, because under California law, the purchaser of assets does not assume successor liability.

- Pursuant to § 363(f)(4), the validity of the Additional Conditions is subject to a *bona fide* dispute, because the Attorney General abused his discretion in imposing the Additional Conditions.

- Pursuant to § 363(f)(5), the Attorney General could be compelled to accept a money satisfaction of certain of the Additional Conditions, such as the condition that SGM provide specified levels of charitable care.

The Debtors assert that imposition of the Additional Conditions violates § 525, which prohibits government entities from discriminating against debtors who have failed to pay dischargeable debts when issuing licenses. According to the Debtors, the Additional Conditions constitute an attempt by the Attorney General to collect a dischargeable debt. The Debtors' theory is that Attorney General's refusal to approve the SGM Sale absent imposition of the Additional Conditions amounts to the discriminatory denial of licensure in contravention of § 525.

Finally, the Debtors request that the Court issue a writ of mandate compelling the Attorney General to approve the SGM Sale without imposition of the Additional Conditions, pursuant to Cal. Civ. Proc. Code § 1085 or § 1094.5. The Debtors assert that a writ of mandate is justified because the Attorney General abused his discretion by imposing the Additional Conditions.

The Committee supports the Motion. The Committee argues that prompt closing of the SGM Sale is the best means of insuring a distribution to unsecured creditors.

The Attorney General opposes the Motion. He disputes the Debtors' contention that the Hospitals may be sold under applicable nonbankruptcy law, or that a bona fide dispute exists as to the Attorney General's authority to impose the Additional Conditions. The Attorney General denies that he abused his discretion in imposing the Additional Conditions. He notes that he considered an extensive record in arriving at the Additional Conditions, and states that the Debtors' dislike of the Additional Conditions does not mean that imposing the conditions was an abuse of discretion.

Service Employees International Union, United Healthcare Workers-West ("SEIU-UHW"), which represents approximately 1,303 employees at St. Vincent and St. Francis, opposes the Motion. SEIU-UHW contends that the Additional Conditions are economically feasible for SGM.

The United Nurses Association of California/Union of Health Care Professional ("UNAC"), which represents approximately 900 registered nurses at St. Francis, urges SGM, the Attorney General, and the Debtors to explore prospects for a consensual resolution with respect to the Additional Conditions.

**II. Discussion**

Section 363(d)(1) authorizes non-profit entities, such as the Debtors, to sell estate assets only if the sale is "in accordance with nonbankruptcy law applicable to the transfer of property by" a non-profit entity. Section 541(f) similarly provides that property held by debtors that are § 501(c)(3) corporations under the Internal Revenue Code may be transferred, but "only under the same conditions as would apply if the debtor had not filed a case under this title." Section 363(b) authorizes the Debtors to sell estate property out of the ordinary course of business, subject to court approval. The Debtors must articulate a business justification for the sale. *In re Walter*, 83 B.R. 14, 19–20 (9th Cir. BAP 1988). Whether the articulated business justification is sufficient "depends on the case," in view of "all salient factors pertaining to the proceeding." *Id.* at 19–20. Section 363(f) provides that a sale of estate property may be "free and clear of any interest in such property of an entity other than the estate," provided that certain conditions are satisfied.

**A. The Additional Conditions are an "Interest in Property" Within the Meaning of § 363(f)**

***5** As this Court has previously explained:

> The Bankruptcy Code does not define the phrase "interest in ... property" for purposes of § 363(f). The Third Circuit has held that the phrase "interest in ... property" is "intended to refer to obligations that are connected to, or arise from, the property being sold." *Folger Adam Sec., Inc. v. DeMatteis/MacGregor JV*, 209 F.3d 252, 259 (3d Cir. 2000). That conclusion is echoed by *Collier on Bankruptcy*, which observes a trend in caselaw "in favor of a broader definition [of the phrase] that encompasses other obligations that may flow from ownership of the property." 3 Alan N. Resnick & Henry J. Sommer, *Collier on Bankruptcy* ¶ 363.06[1] (16th ed. 2017).
>
> Courts have held that interests in property include monetary obligations arising from the ownership of property, even when those obligations are imposed by statute. For example, in *Mass. Dep't of Unemployment Assistance v. OPK Biotech, LLC (In re PBBPC, Inc.)*, 484 B.R. 860 (1st Cir. BAP 2013), the court held that taxes assessed by Massachusetts under its unemployment insurance statutes constituted an "interest in ... property." The taxes were computed based on the Debtor's "experience rating," which was determined by the number of employees it had terminated in the past. *Id.* at 862. Because the Debtor had terminated most of its employees prior to selling its assets, its experiencing rating, and corresponding unemployment insurance tax liabilities, were very high. *Id.* The *PBBPC* court held that the experience rating was an interest in property that could be cut off under § 363(f). *Id.* at 869–70. Similarly, in *United Mine Workers of Am. Combined Benefit Fund v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573, 581, the court held that monetary obligations imposed by the Coal Industry Retiree Health Benefit Act of 1992 constituted an "interest in ... property" within the meaning of § 363(f).
>
> *In re Gardens Reg'l Hosp. & Med. Ctr., Inc.*, 567 B.R. 820, 825–26 (Bankr. C.D. Cal. 2017), *appeal dismissed*, No. 2:16-BK-17463-ER, 2018 WL 1229989 (C.D. Cal. Jan. 19, 2018) ("*Gardens I*").

The Additional Conditions are an "interest in property" within the meaning of § 363(f). First, the Additional Conditions are monetary obligations arising from the ownership of property. Similar to the "experience rating" at issue in *PBBPC, Inc.*, the Additional Conditions were calculated based upon the Hospitals' prior operating history. Among other things, the Additional Conditions require that SGM cause the Hospitals to provide specified levels of healthcare

services. The required service levels have been set based upon the Hospitals' historical operations. For example, the Additional Conditions require that St. Francis "maintain and provide 24-hour emergency and trauma medical services at no less than current licensure and designation with the same types and/or levels of services ...."[6] St. Francis is required to maintain cardiac services, critical care services, neonatal intensive services, women's health services, cancer services, pediatric services, orthopedic and rehabilitation services, wound care services, behavioral health services, and perinatal services, all at "current licensures, types, and/or levels of services."[7] St. Vincent, Seton, and Seton Coastside are also required to maintain various healthcare services at current levels.[8]

*6 Second, the Attorney General's statutory authority to impose the Additional Conditions arises from the Debtors' operation of the Hospitals as non-profit entities. Had the Debtors not operated the Hospitals in this manner, there could be no contention that the SGM Sale is subject to the Attorney General's review pursuant to Cal. Corp. Code § 5914. In this sense as well, the Additional Conditions "arise from the property being sold," *In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3d Cir. 2003), and therefore qualify as an "interest in ... property" within the meaning of § 363(f).

Third, the Attorney General is barred by the law of the case doctrine from asserting that the Additional Conditions are not an "interest in ... property." "Under the 'law of the case' doctrine, a court is ordinarily precluded from reexamining an issue previously decided by the same court, or a higher court, in the same case." *Richardson v. United States*, 841 F.2d 993, 996 (9th Cir.), *amended*, 860 F.2d 357 (9th Cir. 1988). "For the doctrine to apply, the issue in question must have been 'decided explicitly or by necessary implication in [the] previous disposition.' " *United States v. Lummi Indian Tribe*, 235 F.3d 443, 452 (9th Cir. 2000).

In connection with the Santa Clara Sale, the Court addressed the exact issue presented here—whether conditions that the Attorney General sought to impose upon the sale constituted an "interest in ... property" for purposes of § 363(f).[9] The Attorney General litigated the issue, and the Court overruled the Attorney General's arguments.[10] The Attorney General voluntarily dismissed his appeal of the order finding that the conditions he sought to impose were an "interest in ... property." The law of the case doctrine bars relitigation of the issue.

The doctrine of issue preclusion is a further bar to any attempt by the Attorney General to contest the Additional Conditions' status as an "interest in ... property." As explained by the Supreme Court, issue preclusion forecloses " 'successive litigation of an issue of fact or law actually litigated and resolved in a valid court determination essential to the prior judgment,' even if the issue recurs in the context of a different claim." *Taylor v. Sturgell*, 553 U.S. 880, 892, 128 S. Ct. 2161, 2171, 171 L. Ed. 2d 155 (2008) (internal citations omitted). The doctrine protects "against 'the expense and vexation attending multiple lawsuits, conserve[s] judicial resources, and foster[s] reliance on judicial action by minimizing the possibility of inconsistent decisions.' " *Id.* Issue preclusion applies if "(1) the issue at stake was identical in both proceedings; (2) the issue was actually litigated and decided in the prior proceedings; (3) there was a full and fair opportunity to litigate the issue; and (4) the issue was necessary to decide the merits." *Howard v. City of Coos Bay*, 871 F.3d 1032, 1041 (9th Cir. 2017).

The Attorney General has litigated the issue presented here, both in connection with the Santa Clara Sale and in connection with a sale in *Gardens I* (the "Gardens Sale"). Just as he did in the Santa Clara Sale, the Attorney General claimed in the Gardens Sale the regulatory authority to impose conditions. The Court found that the Attorney General's claim to regulatory authority was an "interest in ... property" for purposes of § 363(f). *Gardens I*, 567 B.R. at 826. The Attorney General is precluded from relitigating the issue of whether his claimed authority to impose conditions on the SGM Sale is an "interest in ... property."

**B. The Debtors May Sell the Hospitals Free and Clear of the Additional Conditions Pursuant to § 363(f)(1)**

*7 Sale of the Hospitals may be free and clear of the Additional Conditions only upon satisfaction of one or more of the five disjunctive sub-factors set forth in § 363(f). Under § 363(f)(1), a sale free and clear may be approved if permitted by applicable nonbankruptcy law.

Applicable nonbankruptcy law permits a sale free and clear for two reasons. First, the Attorney General's attempt to impose the Additional Conditions upon SGM is equivalent to an attempt to impose successor liability upon SGM. California law does not authorize the imposition of successor liability upon SGM. Second, even if the Attorney General were authorized to impose successor liability under California law, the Attorney General abused his discretion in imposing

the Additional Conditions, meaning that the Additional Conditions must be set aside.

1. California Law Does Not Authorize the Attorney General to Impose Successor Liability Upon SGM

*i. The Additional Conditions Qualify as Successor Liability*

The Attorney General's attempt to impose the Additional Conditions upon SGM qualifies as an attempt to impose successor liability upon SGM. The reason is that the Additional Conditions impose upon SGM many of the same obligations imposed upon the Debtors by the 2015 Conditions. By attempting to enforce the Additional Conditions, the Attorney General is attempting to enforce the obligations imposed by the 2015 Conditions against SGM.

It is true that the 2015 Conditions are not identical to the Additional Conditions. Some medical services required under the 2015 Conditions are no longer required under the Additional Conditions. And unlike the 2015 Conditions, the Additional Conditions do not impose obligations to fund pension plans. But for the most part the Additional Conditions reinstate obligations imposed by the 2015 Conditions. For example, both the 2015 Conditions and the Additional Conditions require that St. Francis maintain cardiac services, including designation as a STEMI Receiving Center; critical care services, including a minimum of 36 intensive care unit beds; neonatal intensive care services, including a minimum of 29 neonatal intensive care beds; women's health services, including women's imaging services; cancer services, including radiation oncology; orthopedic and rehabilitation services; and wound care services. The Additional Conditions do not reinstate St. Francis' obligation to maintain advanced certification as a Primary Stroke Center, and the Additional Conditions reduce St. Francis' pediatric services obligation from 14 beds to 5 beds.

The 2015 Conditions required St. Francis to maintain the specified healthcare services for ten years from the date of the closing of the Restructuring Agreement. The Additional Conditions require that the specified services be maintained for ten years from the date of the closing of the APA. That is, the Additional Conditions extend the term of the 2015 Conditions by approximately six years.

Considered within the overall scope of the obligations imposed, the differences between the 2015 Conditions and the Additional Conditions are comparatively inconsequential. The Attorney General relies upon these minor differences in support of his argument that the Additional Conditions do not impose successor liability. Such reliance is misplaced. The Additional Conditions still qualify as successor liability even though they are not exactly identical to the 2015 Conditions. Nor does the extension in the term of the reinstituted obligations remove the Additional Conditions from the category of successor liability.

***8** The Attorney General argues that the Additional Conditions do not impose successor liability because they are SGM's own obligations, going forward from the date of the sale. According to the Attorney General, the Additional Conditions are based upon healthcare impact reports prepared for each Hospital. The Attorney General asserts that it is not surprising that the Additional Conditions resemble the 2015 Conditions, which are only four years old and relate to the same Hospitals and communities. Citing *In re General Motors Corp.*, 407 B.R. 463, 508 (Bankr. S.D.N.Y. 2009), the Attorney General analogizes the Additional Conditions to the environmental remediation liabilities that would remain the obligation of a purchaser of contaminated real estate.

These arguments are not persuasive. In *General Motors*, the environmental remediation obligations were not successor liability because any entity purchasing contaminated property would have an obligation to comply with environmental law:

> Under section 363(f), there could be no successor liability imposed on the purchaser for the [seller's] ... monetary obligations related to cleanup costs, or any other obligations that were obligations of the seller. But the purchaser would have to comply with its environmental responsibilities starting with the day it got the property, and if the property required remediation as of that time, any such remediation would be the buyer's responsibility .... Those same principles will be applied here. Any Old GM properties to be transferred will be transferred free and clear of successor liability, but New GM will be liable from the day it gets any such properties for its environmental responsibilities going forward.

*In re Gen. Motors Corp.*, 407 B.R. 463, 508 (Bankr. S.D.N.Y. 2009).

There is a key difference between the contaminated property at issue in *General Motors* and the Hospitals at issue here. Any entity that purchased the contaminated property at issue in *General Motors* would have been required to comply with environmental regulations going forward. A purchaser's duty to comply with environmental regulations would not vary based upon the identity of the purchaser or the identity

of the seller. Here, by contrast, whether a purchaser is obligated to comply with Attorney General conditions can vary, depending upon either the identity of the purchaser or the identity of the seller. There is no general obligation imposed upon an entity that purchases a hospital in the State of California to operate that hospital in accordance with conditions asserted by the Attorney General. The Attorney General's regulatory authority applies only to non-profit hospitals, and only to certain types of sale transactions. Had the Hospitals been sold to a public entity, such as the County of Los Angeles, the Attorney General could not have reviewed the sale. *See Verity I*, 598 B.R. at 294 (holding that Cal. Corp. Code § 5914 did not apply where non-profit hospitals were sold to a public entity). Had the Hospitals been operated by a for-profit entity, the Attorney General could not have reviewed the sale. *See* Cal. Corp. Code § 5914(a) (requiring only nonprofit corporations to submit the sale of assets to Attorney General review).

Because the obligation to comply with the Additional Conditions is contingent upon the identity of the purchaser and the identity of the seller, the conditions cannot fairly be characterized as the purchaser's obligation to comply with applicable law on a going-forward basis. The Attorney General can claim authority to impose the Additional Conditions upon purchaser SGM only because the Debtors operated the Hospitals as non-profit entities. Since the Attorney General's alleged authority to impose the Additional Conditions derives from the manner in which the sellers operated the Hospitals, the Additional Conditions are appropriately characterized as successor liability.

*ii. Successor Liability Cannot Be Imposed Under California Law*

***9** Under California law, the general rule is "that where a corporation purchases, or otherwise acquires by transfer, the assets of another corporation, the acquiring corporation does not assume the selling corporation's debts and liabilities." *Fisher v. Allis-Chalmers Corp. Prod. Liab. Tr.*, 95 Cal. App. 4th 1182, 1188, 116 Cal. Rptr. 2d 310, 315 (2002). The general rule does not apply if "(1) there is an express or implied agreement of assumption, (2) the transaction amounts to a consolidation or merger of the two corporations, (3) the purchasing corporation is a mere continuation of the seller, or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts." *Id.*

None of the exceptions to the general rule are present here. First, SGM has not agreed to assume the Additional Conditions, either expressly or by implication. Second, the SGM Sale is not a consolidation or merger of the Debtors and SGM. A sale transaction is a consolidation or merger of two corporations "where one corporation takes all of another's assets without providing any consideration that could be made available to meet claims of the other's creditors or where the consideration consists wholly of shares of the purchaser's stock which are promptly distributed to the seller's shareholders in conjunction with the seller's liquidation." *Ray v. Alad Corp.*, 19 Cal. 3d 22, 28, 136 Cal.Rptr. 574, 560 P.2d 3 (1977) (internal citations omitted). Neither factor applies. SGM is paying for the Hospitals in cash (not stock),[11] and that cash will be distributed to the Debtors' creditors through a plan of liquidation. Third, SGM is not a mere continuation of the Debtors. A purchaser is a mere continuation of a seller if there is inadequate consideration for the purchaser or if one or more persons are officers, directors, or stockholders or both corporations. *Id.* Consideration for the SGM Sale is adequate and no officers or directors of the Debtors are officers or directors of SGM.[12] Fourth, the Debtors are not selling the Hospitals for the purpose of escaping liabilities for their debts. In fact, the opposite is true—the objective of the SGM Sale is to generate proceeds to pay the Debtors' debts, to the extent possible. In sum, successor liability cannot be imposed on SGM under California common law.

Successor liability cannot be imposed under Cal. Corp. Code §§ 5914–5919. Cal. Corp. Code § 5914 authorizes the Attorney General to review transactions in which a non-profit healthcare facility seeks to transfer a material amount of its assets to a for-profit entity, and provides in relevant part:

> Any nonprofit corporation that is defined in Section 5046 and operates or controls a health facility, as defined in Section 1250 of the Health and Safety Code, or operates or controls a facility that provides similar health care, regardless of whether it is currently operating or providing health care services or has a suspended license, shall be required to provide written notice to, and to obtain the written consent of, the Attorney General prior to entering into any agreement or transaction to do either of the following:
>
> > (A) Sell, transfer, lease, exchange, option, convey, or otherwise dispose of, its assets to a for-profit corporation or entity or to a mutual benefit corporation or entity when a material amount of the assets of the nonprofit corporation are involved in the agreement or transaction.

Cal. Corp. Code § 5914(a)(1) (West).

The "Attorney General shall have discretion to consent to, give conditional consent to, or not consent to" the transaction. Cal. Corp. Code § 5917.

***10** Nothing within the statute authorizes the Attorney General to impose successor liability upon SGM, the for-profit entity that purchased the healthcare assets from the non-profit Debtors. Under the statute, the Attorney General is authorized to review transactions entered into by a "nonprofit corporation that ... operates or controls a health facility," Cal. Corp. Code § 5914(a)(1), and to "consent to, give conditional consent to, or not consent to" any such transactions, Cal. Corp. Code § 5917. These provisions do not grant the Attorney General authority to impose going-forward obligations on the assets that are the subject of the transaction. That is, the statute does not provide that the healthcare assets themselves are subject to regulation by the Attorney General. Rather, it is the non-profit status of the entity operating the healthcare assets that triggers the Attorney General's regulatory authority. Upon transfer of the healthcare assets from the non-profit entity to the for-profit entity, the Attorney General's regulatory authority over the assets terminates.

The issue of the Attorney General's authority to impose successor liability arose in the case of *In re La Paloma Generating Co.*, No. 16-12700, 2017 WL 5197116 (Bankr. D. Del. Nov. 9, 2017). In *La Paloma*, the debtor operated a power plant subject to a cap-and-trade emissions regulation. The regulation required "Covered Entities"—defined as entities engaging in operations that generated emissions—to surrender "Compliance Instruments" equal to the amount of emissions generated at specified times. At issue was whether a power plant could be sold "free and clear of, and without the purchaser assuming, any obligation to surrender compliance instruments under the California Cap-and-Trade Program for emissions generated by the Debtors and/or their facility during the period before the transfer of the assets." *Id.* at *2. The court found that "[u]nder the Regulation, only entities—and not assets—are Covered Entities" subject to the obligation to surrender Compliance Instruments. *Id.* at *5. As a result, the court found, the debtors could sell the power plant free and clear of the surrender obligations, pursuant to § 363(f)(1). *Id.* at *8. The court reasoned that the regulation did not impose successor liability on the purchaser, because it imposed liability only on "Covered Entities," and the purchaser would not become a Covered Entity until after it acquired the power plant. *Id.* at *7–*8. The regulation, the court held, was limited to Covered Entities, and could not be used to "impugn liability on the purchaser of ... the Covered Entity's assets." *Id.* at *8.

With respect to the imposition of successor liability, the statute at issue here operates in the same manner as the regulation examined in *La Paloma*. Similar to the regulation in *La Paloma*, Cal. Corp. Code § 5914–5919 permits the imposition of liability upon the Hospitals only because they are operated by a non-profit corporation. That is, independent of the fact that they are operated by a non-profit entity, nothing within Cal. Corp. Code § 5914–5919 authorizes the Attorney General to impose liabilities upon the Hospitals. Further, the Attorney General's regulatory authority under the statute does not extend to for-profit entities. As was the case in *La Paloma*, Cal. Corp. Code § 5914–5919 does not authorized the Attorney General to impose liability upon the for-profit purchaser of the Hospitals.

The Attorney General argues that the statute's implementing regulations authorize the imposition of successor liability. Specifically, the Attorney General points to Cal. Code Regs. Tit. 11, § 999.5, which provides in relevant part:

> It is the policy of the Attorney General, in consenting to an agreement or transaction involving a general acute care hospital, to require for a period of at least five years the continuation at the hospital of existing levels of essential healthcare services, including but not limited to emergency room services. The Attorney General shall retain complete discretion to determine whether this policy shall be applied in any specific transaction under review.
>
> ***11** Cal. Code Regs. tit. 11, § 999.5.

Significantly, the statute's implementing regulations do not differentiate between Cal. Corp. Code §§ 5914–5919, which codifies the Attorney General's authority to review transfers between a non-profit and a for-profit entity, and Cal. Corp. Code §§ 5920–5925, which codifies the Attorney General's authority to review transfers between a non-profit entity and a different non-profit entity. Where assets are transferred between two different non-profit entities, the structure of the statute clearly provides the Attorney General the authority to impose successor liability.

The Court construes Cal. Code Regs. Tit. 11, § 999.5 as implementing Cal. Corp. Code §§ 5920–5925, not as implementing Cal. Corp. Code §§ 5914–5919. Cal. Corp. Code §§ 5920–5925 does authorize the imposition of successor liability, whereas Cal. Corp. Code §§ 5914–5919

does not. This construction is appropriate because it harmonizes the language of the regulation with the language of the statute, while still giving full effect to every part of the regulation. *See Butts v. Bd. of Trustees of California State Univ.*, 225 Cal. App. 4th 825, 835, 170 Cal. Rptr. 3d 604, 612 (2014) ("The rules of statutory construction also govern our interpretation of regulations promulgated by administrative agencies. We give the regulatory language its plain, commonsense meaning. If possible, we must accord meaning to every word and phrase in the regulation, and we must read regulations as a whole so that all of the parts are given effect.").

Because the Attorney General's authority to review the sale arises under Cal. Corp. Code §§ 5914–5919, the Attorney General cannot rely upon Cal. Code Regs. tit. 11, § 999.5, which implements Cal. Corp. Code §§ 5920–5925, as the basis for imposing successor liability upon SGM.

2. Even if California Law Allowed the Attorney General to Impose Successor Liability Upon SGM, the Attorney General Abused his Discretion in Imposing the Additional Conditions

As set forth below, the Court finds that the Attorney General's decision to impose the Additional Conditions is subject to judicial review by administrative mandate under California law. This Court is empowered to conduct such judicial review pursuant to § 1221(e) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), which provides:

> Nothing in this section shall be construed to require the court in which a case under chapter 11 of title 11, United States Code, is pending to remand or refer any proceeding, issue, or controversy to any other court or to require the approval of any other court for the transfer of property.

Pub. L. No. 109-8, § 1221(e) (2005).[13] *See also In re HHH Choices Health Plan, LLC*, 554 B.R. 697, 700 (Bankr. S.D.N.Y. 2016) (construing New York state law to determine the appropriate disposition of a non-profit debtor's assets).

Upon review of the Attorney General's decision, the Court finds that the imposition of the Additional Conditions constituted an abuse of discretion, for the reasons explained below. Therefore, the Additional Conditions must be set aside, which means that the Debtors are authorized to sell the Hospitals free and clear of the Additional Conditions under applicable nonbankruptcy law.

*i. The Attorney General's Imposition of the Additional Conditions is Subject to Judicial Review by Administrative Mandate*

***12** Cal. Civ. Proc. Code § 1094.5 provides for judicial review by administrative mandate of decisions made by agencies or officers of the State of California. A writ of mandate may be issued if the agency or officer making the decision engaged in a "prejudicial abuse of discretion." Cal. Civ. Proc. Code § 1094.5(b). An "abuse of discretion is established if ... the order or decision is not supported by the findings, or the findings are not supported by the evidence." *Id.*

The Attorney General contends that administrative mandamus review is not available because the Additional Conditions were not issued subsequent to "a proceeding in which by law a hearing is required to be given, evidence is required to be taken, and discretion in the determination of facts is vested in the inferior tribunal." Cal. Civ. Proc. Code § 1094.5(a). The Attorney General acknowledges that he conducted "public meetings ... to hear comments from interested parties" as required by Cal. Corp. Code § 5922. However, the Attorney General asserts that such public meetings were not "hearings" within the meaning of Cal. Civ. Proc. Code § 1094.5(a), because public comments were not presented under oath and no effort was made to determine the accuracy of the information offered by members of the public. The Attorney General's position is that the Debtors are entitled only to traditional mandamus review under Cal. Civ. Proc. Code § 1085.

"Quasi-legislative acts are ordinarily reviewed by traditional mandate, and quasi-judicial acts are reviewed by administrative mandate. 'Generally speaking, a legislative action is the formulation of a rule to be applied to all future cases, while an adjudicatory act involves the actual application of such a rule to a specific set of existing facts.' " *Friends of the Old Trees v. Dep't of Forestry & Fire Prot.*, 52 Cal. App. 4th 1383, 1389, 61 Cal. Rptr. 2d 297, 303 (1997) (internal citation omitted).

The Court is not persuaded by the Attorney General's contention that administrative mandamus review is unavailable to the Debtors. In reviewing the SGM Sale, the Attorney General hired JD Healthcare, Inc. to prepare expert reports containing information on how the SGM Sale would affect the availability of healthcare services in the regions served by the Hospitals. The JD Healthcare expert reports contained recommendations regarding the conditions that the

Attorney General should impose on the SGM Sale. Upon receiving the expert reports, the Attorney General asked the Debtors to respond to the conditions recommended by JD Healthcare. The Attorney General conducted public meetings, all of which were transcribed, at which members of the public commented on the SGM Sale. "[P]urely documentary proceedings can satisfy the hearing requirement of Code of Civil Procedure § 1094.5, so long as the agency is required by law to accept and consider evidence from interested parties before making its decision." *Friends of the Old Trees*, 52 Cal. App. 4th at 1391–92, 61 Cal.Rptr.2d 297. A "trial-type hearing" is not necessary. *Id.* at 1392, 61 Cal. Rptr. 2d 297.

The Attorney General's review involved "the actual application of ... a rule to a specific set of existing facts." *Friends*, 52 Cal. App. 4th at 1389, 61 Cal.Rptr.2d 297. The Attorney General received evidence from JD Healthcare, heard comments from members of the public, and elected to impose the Additional Conditions after considering all the evidence collected during the review process. The Attorney General's review of the SGM Sale was a quasi-judicial act subject to review by administrative mandate.

***13** The Attorney General next asserts that administrative mandamus review is unavailable because the Debtors have failed to produce the complete administrative record supporting the Attorney General's decision. This contention is without merit. For purposes of administrative mandamus review, a partial record is sufficient if it "accurately represent[s] the administrative proceedings, provide[s] the reviewing court with an understanding of what occurred below, and enable[s] that court to undertake an independent judicial review of the administrative decision." *Elizabeth D. v. Zolin*, 21 Cal. App. 4th 347, 349, 25 Cal. Rptr. 2d 852 (1993). The record before the Court consists of the expert reports prepared by JD Healthcare, partial transcripts of public meetings conducted by the Attorney General, and various letters submitted by stakeholders. The record on file provides the Court with an understanding of reasons for the Attorney General's decision.

There are two tests for judicial review by administrative mandate. "The 'independent judgment' rule applies when the decision of an administrative agency will substantially affect a fundamental vested right." *Mann v. Dep't of Motor Vehicles*, 76 Cal. App. 4th 312, 320, 90 Cal. Rptr. 2d 277, 283 (1999). Under the "independent judgment" rule, the Court must "begin its review with a presumption of the correctness of administrative findings, and then, after affording the respect due to these findings, exercise independent judgment in making its own findings." *Fukuda v. City of Angels*, 20 Cal. 4th 805, 819, 85 Cal.Rptr.2d 696, 977 P.2d 693, 701 (1999). "[T]he presumption provides the trial court with a starting point for review but it is only a presumption, and may be overcome. Because the trial court ultimately must exercise its own independent judgment, that court is free to substitute its own findings after first giving due respect to the agency's findings." *Id.*

"The 'substantial evidence' rule applies when the administrative decision neither involves nor substantially affects a vested right. The trial court must then review the entire administrative record to determine whether the findings are supported by substantial evidence and whether the agency committed any errors of law ...." *Mann*, 76 Cal. App. 4th 312, 320, 90 Cal. Rptr. 2d 277, 283 (1999).

To determine whether an administrative decision affects a fundamental vested right, the Court examines "whether the affected right is deemed to be of sufficient significance to preclude its extinction or abridgement by a body lacking *judicial* power." *Interstate Brands v. Unemployment Ins. Appeals Bd.*, 26 Cal. 3d 770, 779, 163 Cal.Rptr. 619, 608 P.2d 707, 713 (1980) (emphasis in original). An administrative decision that would have the effect of shutting down a business affects a fundamental vested right. *See, e.g.*, *The Termo Co. v. Luther*, 169 Cal. App. 4th 394, 407–08, 86 Cal. Rptr. 3d 687, 697 (2008) ("The implementation of the Order and Decision would have the effect not only of shutting down a business that has been in existence for 20 years or more, but also of terminating the right to produce oil—an extraordinarily valuable resource, especially in the current economic era.... Certainly, a fundamental vested right is at issue."); *Goat Hill Tavern v. City of Costa Mesa*, 6 Cal. App. 4th 1519, 1529, 8 Cal. Rptr. 2d 385, 391 (1992) (holding that "the right to continue operating an established business in which [the owner] has made a substantial investment" is a fundamental vested right).

Imposition of the Additional Conditions will precipitate the collapse of the SGM Sale and require the Debtors to close three of the four Hospitals. The Debtors' rights to preserve the Hospitals' operations, by means of a sale to SGM, is a fundamental vested right that is abrogated by the Attorney General's attempt to impose the Additional Conditions. Consequently, the Court reviews the Attorney General's decision under the independent judgment test.

*ii. In Imposing the Additional Conditions, the Attorney General Abused His Discretion*

*14 Under certain circumstances, the sale of a not-for-profit healthcare facility is subject to review by the Attorney General. Cal. Corp. Code § 5914. The Legislature enacted Cal. Corp. Code § 5914 to ensure that the public was not deprived of the benefits of charitable health facilities as a result of the transfer of those facilities' assets to for-profit entities. In enacting § 5914, the Legislature found:

> Charitable, nonprofit health facilities have a substantial and beneficial effect on the provision of health care to the people of California, providing as part of their charitable mission uncompensated care to uninsured low-income families and under-compensated care to the poor, elderly, and disabled.
>
> Transfers of the assets of nonprofit, charitable health facilities to the for-profit sector, such as by sale, joint venture, or other sharing of assets, directly affect the charitable use of those assets and may affect the availability of community health care services....
>
> It is in the best interests of the public to ensure that the public interest is fully protected whenever the assets of a charitable nonprofit health facility are transferred out of the charitable trust and to a for-profit or mutual benefit entity.

1996 Cal. Legis. Serv. Ch. 1105 (A.B. 3101) (West).

The Attorney General has "discretion to consent to, give conditional consent to, or not consent to" the sale of a healthcare facility. Cal. Corp. Code § 5917. In exercising that discretion, the Attorney General "shall consider any factors that the Attorney General deems relevant," including but not limited to whether any of the following apply:

a) The terms and conditions of the agreement or transaction are fair and reasonable to the nonprofit corporation.

b) The agreement or transaction will result in inurement to any private person or entity.

c) Any agreement or transaction that is subject to this article is at fair market value. In this regard, "fair market value" means the most likely price that the assets being sold would bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and in their own best interest, and a reasonable time being allowed for exposure in the open market.

d) The market value has been manipulated by the actions of the parties in a manner that causes the value of the assets to decrease.

e) The proposed use of the proceeds from the agreement or transaction is consistent with the charitable trust on which the assets are held by the health facility or by the affiliated nonprofit health system.

f) The agreement or transaction involves or constitutes any breach of trust.

g) The Attorney General has been provided, pursuant to Section 5250, with sufficient information and data by the nonprofit corporation to evaluate adequately the agreement or transaction or the effects thereof on the public.

h) The agreement or transaction may create a significant effect on the availability or accessibility of health care services to the affected community.

i) The proposed agreement or transaction is in the public interest.

j) The agreement or transaction may create a significant effect on the availability and accessibility of cultural interests provided by the facility in the affected community.

Cal. Corp. Code § 5917 (West).

Nothing in the record indicates that SGM's bid was other than for fair market value (factor (c)). The Hospitals were thoroughly marketed by Cain Brothers. SGM was the only bidder interested in purchasing the Hospitals. The Court must presume that a bid submitted after extensive marketing reflects the Hospital's fair market value. *See Bank of Am. Nat. Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457, 119 S. Ct. 1411, 1423, 143 L. Ed. 2d 607 (1999) (stating that "the best way to determine value is exposure to a market").

*15 There is no indication that SGM, or any other party, took any actions to decrease the value of the Hospitals (factor (d)). In view of the extensive marketing, the terms of the sale are fair and reasonable to the Debtors (factor (a)). There is no evidence that any of the parties involved in the SGM sale have engaged in any conduct that would amount to a breach of trust (factor (f)), or that the SGM Sale will inure to the benefit of any private person or entity (factor (b)). Nor has

there been any suggestion that the Debtors failed to provide the Attorney General with sufficient information to evaluate the SGM Sale (factor (g)). Factor (e) does not apply, because the proceeds of the SGM Sale are fully encumbered by the claims of creditors, leaving no remaining equity that could be devoted to charitable purposes.

The remaining factors are (1) the effect of the SGM Sale on the accessibility of healthcare services (factor (h)) and cultural interests (factor (j)) in the affected communities and (2) whether the SGM Sale is in the public interest (factor (i)). Applying the independent judgment standard of review, the Court finds that in electing to impose the Additional Conditions, the Attorney General abused his discretion with respect to these factors.

By letter dated August 23, 2019 (the "August Letter"), the Debtors advised the Attorney General that if the Additional Conditions were imposed, SGM would not complete the sale and the most likely outcome would be the closure of St. Vincent, Seton, and Seton Coastside. The August Letter advised the Attorney General that SGM had submitted the only offer for the Hospitals, and that the "Debtors cannot sustain incurring ongoing operational losses to maintain the going-concern value of St. Vincent and Seton without the realistic prospect of a purchaser."[14] The Debtors stated that upon the failure of the SGM Sale, they would be required to begin the process of closing St. Vincent, Seton, and Seton Coastside "almost immediately."[15]

Having overseen the Debtors' bankruptcy cases since their inception, the Court has become intimately familiar with the Debtors' operational and cash flow situation. As discussed above, the Debtors' statements regarding the necessity of closing certain of the Hospitals upon the failure of the SGM Sale are not an idle threat.

Imposition of the Additional Conditions will dramatically reduce the availability of healthcare services by causing the closure of three of the four Hospitals. In addition to the loss of healthcare services, closure of the Hospitals will destroy approximately 2900 jobs. Closure of the Hospitals will require the relocation of many patients suffering from critical conditions. None of this is in the public interest.[16]

The Court understands that the Additional Conditions were imposed with the laudable objective of increasing the amount of healthcare services provided by the Hospitals. The Court can only assume that the Attorney General does not believe the representation that imposition of the Additional Conditions will result in a collapse of the SGM Sale. Unfortunately, the dire economic circumstances in which the Debtors now find themselves leaves the Court with no doubt that if the SGM Sale is not completed, three of the Hospitals will almost certainly close.

Because the Additional Conditions will reduce health care services by resulting in the closure of three of the Hospitals, imposition of the Additional Conditions was an abuse of the Attorney General's discretion.

***16** Outside of bankruptcy, the finding that the Attorney General abused his discretion would result in the entry of a judgment commanding the issuance of a peremptory writ of mandate, followed by the issuance of the writ. The writ would command the Attorney General to set aside the 2019 Conditions, and would further command the Attorney General to exercise his discretion with respect to the review of the SGM Sale in a lawful manner. *See, e.g.*, *California Hosp. Assn. v. Maxwell-Jolly*, 188 Cal. App. 4th 559, 570, 115 Cal. Rptr. 3d 572, 581 (2010), *as modified on denial of reh'g* (Sept. 16, 2010).

BAPCPA § 1221(e) compels a different result inside bankruptcy. Section 1221(e) provides that the Court is not required "to remand or refer any proceeding, issue, or controversy to any other court or to require the approval of any other court for the transfer of property." In *In re HHH Choices Health Plan*, the Bankruptcy Court relied upon BAPCPA § 1221(e) to conclude that it had the authority to interpret a New York law governing the transfer of the assets of a nonprofit entity. The court observed that "[i]n the case of an insolvent not-for-profit corporation, section 511 of the New York Not-For-Profit Corporation Law ordinarily, would require the approval of the New York State Supreme Court for a transfer of assets." *HHH Choices Health Plan*, 554 B.R. at 700. The court rejected arguments advanced by certain of the parties "that the ordinary state court procedures must still be followed" with respect to the transfer of the assets. *Id.* Instead, the court held that substantive state law requirements remained applicable, but that it was the Bankruptcy Court that had authority to apply those requirements. *Id.*

Pursuant to BAPCPA § 1221(e), and consistent with the ruling in *HHH Choices Health Plan*, the Court is not required to issue a judgment and writ commanding the Attorney General to set aside the 2019 Conditions, and is not required to remand these proceedings to allow the Attorney General to conduct a

further review of the SGM Sale in light of the Court's finding that the Attorney General abused his discretion. Instead, the Court is empowered to apply Cal. Corp. Code § 5914, and to determine the conditions under which the Debtors may sell the Hospitals to SGM.

Under the circumstances presented here, the only way that closure of three of the four Hospitals can be avoided is if a sale not subject to the Additional Conditions is approved. A decision by the Attorney General to not consent to the sale, or a decision to consent to the sale subject to conditions other than the Approved Conditions, would constitute an abuse of discretion. That is because SGM, the only entity willing to purchase and continue to operate the Hospitals, will do so only if it is permitted to operate the Hospitals in a manner consistent with the Approved Conditions.

In reaching this conclusion, the Court is not limiting or controlling the discretion vested in the Attorney General, in contravention of Cal. Code Civ. Proc. § 1094.5(f). The Hospitals have been financially distressed for years. A $100 million capital infusion made in connection with the 2015 Restructuring Agreement failed to stabilize the Hospitals' operations. A further capital infusion of $148 million in 2017 failed to restore the Hospitals to financial health. This demonstrates that it was not possible to successfully operate the Hospitals subject to the 2015 Conditions. It should come as no surprise that no buyer exists that is willing to purchase and operate the Hospitals if operations are constrained by Additional Conditions that are substantially similar to the 2015 Conditions. The Attorney General's continued attempts to impose conditions rendering sustainable operation of the Hospitals impossible amounts to an abuse of discretion.

***17** The Attorney General contends that SGM, by refusing to purchase and operate the Hospitals subject to conditions other than the Approved Conditions, is attempting to divest the Attorney General of his regulatory authority by forcing him to accede to a transaction on SGM's terms. This argument ignores the financial and operational realities facing the Hospitals. SGM's refusal to accept the Additional Conditions is not an attempt to blackmail the Attorney General into approving the sale. Such refusal is instead dictated by economic reality.

*iii. Even if the Attorney General's Decision is Subject to Traditional Mandamus Review Under Cal. Civ. Proc. Code § 1085, Imposition of the Additional Conditions Was an Abuse of Discretion*

Even if the Attorney General's review of the sale transaction is a quasi-legislative decision, subject to traditional mandamus review under Cal. Civ. Proc. Code § 1085, the decision to impose the Additional Conditions was an abuse of discretion.

Under Cal. Civ. Proc. Code § 1085, a traditional mandate "may issue to correct the exercise of discretionary legislative power, *but only* if the action taken is so palpably unreasonable and arbitrary as to show an abuse of discretion as a matter of law." *Carrancho v. California Air Res. Bd.*, 111 Cal. App. 4th 1255, 1265, 4 Cal. Rptr. 3d 536, 545 (2003) (emphasis in original). In reviewing quasi-legislative decisions, the "authority of the court is limited to determining whether the decision of the agency was arbitrary, capricious, entirely lacking in evidentiary support, or unlawfully or procedurally unfair." *Fullerton Joint Union High Sch. Dist. v. State Bd. of Educ.*, 32 Cal. 3d 779, 786, 187 Cal.Rptr. 398, 654 P.2d 168, 172 (1982). The Court must ensure that the agency or officer making the decision "has adequately considered all relevant factors, and has demonstrated a rational connection between those factors, the choice made, and the purposes of the enabling statute." *W. States Petroleum Assn. v. Superior Court*, 9 Cal. 4th 559, 577, 38 Cal.Rptr.2d 139, 888 P.2d 1268, 1277 (1995). Traditional mandamus review of a quasi-legislative decision is therefore more deferential than administrative mandamus review of a quasi-judicial decision under the independent judgment standard.

Even applying this more deferential standard of review, the Court finds that the decision to impose the Additional Conditions was an abuse of discretion, and that a proper exercise of discretion required the Attorney General to consent to the sale subject only to the Approved Conditions. Preservation of access to healthcare is one of the factors the Attorney General must consider in reviewing the transaction. *See* Cal. Corp. Code § 5917(h) (requiring the Attorney General to consider whether the "agreement or transaction may create a significant effect on the availability or accessibility of health care services to the affected community"). At the hearing, the Attorney General stated that he imposed the Additional Conditions in furtherance of § 5917(h)'s objective of preserving healthcare access.[17] The effect of the Additional Conditions will be the closure of three of the four Hospitals, which will significantly reduce access to healthcare. There is no "rational connection" between the purpose of the Additional Conditions (preserving healthcare access) and the actual results of the conditions (a severe reduction in healthcare access). *See W. States Petroleum Ass'n*, 38 Cal.Rptr.2d 139, 888 P.2d at 1277. With respect to

three of the four Hospitals, the Attorney General's decision will destroy the very charitable assets that he is charged with protecting.

*18 In sum, regardless of whether the Debtors are entitled to review of the Attorney General's decision under traditional mandamus or administrative mandamus, the Attorney General's decision to impose the Additional Conditions was an abuse of discretion. In the unique circumstances of this case, the Attorney General was required to consent to the SGM Sale without imposing the Additional Conditions. As a result, sale of the Hospitals to SGM free and clear of the Additional Conditions is authorized under applicable nonbankruptcy law. The Court approves the SGM Sale, free and clear of the Additional Conditions, pursuant to § 363(f)(1).

**C. The Debtors May Sell the Hospitals Free and Clear of the Additional Conditions Pursuant to § 363(f)(4)**

Under § 363(f)(4), the Hospitals may be sold free and clear of the Additional Conditions provided the Additional Conditions are "in bona fide dispute ..." A bona fide dispute exists if "there is an objective basis for either a factual or legal dispute as to the validity" of the interest at issue. *In re Octagon Roofing*, 123 B.R. 583, 590 (Bankr. N.D. Ill. 1991). The court "court need not determine the probable outcome of the dispute, but merely whether one exists." *Id.*

The Debtors dispute the Attorney General's authority to impose the Additional Conditions, on the grounds that the (1) Additional Conditions attempt to impose successor liability in a manner not authorized under California law and that (2) the Attorney General abused his discretion in issuing the Additional Conditions. As discussed above, the Debtors have shown that the Attorney General cannot impose the Additional Conditions for both of these reasons. The Debtors have easily satisfied § 363(f)(4), which does not require the Debtors to show that they will prevail upon the dispute—only that a dispute exists.

A bona fide dispute exists for yet another reason. The Debtors have shown that by imposing the Additional Conditions, the Attorney General violated § 525.

Section 525 provides in relevant part:

> [A] governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, deny employment to, terminate the employment of, or discriminate with respect to employment against, a person that is or has been a debtor under this title ... or another person with whom such ... debtor has been associated, solely because such ... debtor is or has been a debtor under this title ... or has not paid a debt that is dischargeable in the case under this title ....

In *In re Aurora Gas, LLC*, the court held that the State of Alaska violated § 525 by refusing to approve the debtor's sale of oil and gas leases unless the purchaser posted a bond of $6 million to pay for the cost of plugging abandoned wells that the purchaser was not acquiring. *In re Aurora Gas, LLC*, No. A16-00130-GS, 2017 WL 4325560 (Bankr. D. Alaska Sept. 26, 2017). The court held that by conditioning approval of the sale upon the posting of a bond, the State was attempting to collect upon the debtor's obligation to pay for the costs of plugging the abandoned wells. Imposition of such a condition, the court found, constituted impermissible discrimination against the debtor and its affiliate, the purchaser of the gas leases, in violation of § 525.

The facts of this case are strikingly similar. Here, the Attorney General has conditioned approval of the SGM Sale upon SGM assuming the obligation to operate the Hospitals in accordance with conditions similar to the 2015 Conditions that are an obligation of the Debtors. As discussed, the Additional Conditions require that SGM maintain and operate the Hospitals at current licensure and service levels. The Additional Conditions amount to an attempt by the Attorney General to enforce the obligations imposed by the 2015 Conditions. The 2015 Conditions are liabilities that are dischargeable in bankruptcy. By conditioning the transfer of the Hospitals upon the assumption of the Additional Conditions, which impose obligations equal to or in excess of the 2015 Conditions, the Attorney General is impermissibly discriminating against the Debtors in violation of § 525.

*19 The fact that the Additional Conditions can be characterized as a regulatory obligation does not change the analysis. Regulatory obligations such as the Additional Conditions qualify as a "debt" under the Bankruptcy Code's broad definition of the term:

> Under the Bankruptcy Code, "debt" means "liability on a claim," 11 U.S.C. § 101(12), and "claim," in turn, includes any "right to payment," § 101(5)(A). We have said that "[c]laim" has "the broadest available definition," *Johnson v. Home State Bank*, 501 U.S. 78, 83, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991), and have held that the "plain meaning of a 'right to payment' is nothing more nor less

> than an enforceable obligation, regardless of the objectives the State seeks to serve in imposing the obligation," *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 559, 110 S.Ct. 2126 [109 L.Ed.2d 588] (1990). See also *Ohio v. Kovacs*, 469 U.S. 274, 105 S.Ct. 705, 83 L.Ed.2d 649 (1985). In short, a debt is a debt, even when the obligation to pay it is also a regulatory condition.

*F.C.C. v. NextWave Pers. Commc'ns Inc.*, 537 U.S. 293, 302–03, 123 S. Ct. 832, 839, 154 L. Ed. 2d 863 (2003).

**D. The Debtors May Sell the Hospitals Free and Clear of Certain of the Additional Conditions Pursuant to § 363(f)(5)**

Under § 363(f)(5), property may be sold free and clear of an interest, if the entity holding the interest "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."

An interest "that can be reduced to a specific monetary value" falls within the scope of § 363(f)(5). *In re Trans World Airlines, Inc.*, 322 F.3d 283, 291 (3d Cir. 2003); *see also In re Vista Marketing Grp. Ltd.*, 557 B.R. 630, 635 (Bankr. N.D. Ill. 2016) ("[O]ne would be hard-pressed to present a clearer example of a situation where the interest-holder could be compelled to accept a money satisfaction of its interest under subsection (f)(5) than the calculable monetary obligation asserted by the District in its surcharge bill and disconnection notice.").

Among the Additional Conditions are requirements that each of the Hospitals provide specified levels of charity care and community benefit services. The Additional Conditions allow any shortfalls in charity care or community benefit services to be satisfied through deficiency payments to tax-exempt entities within the Hospitals' service area. The charity care and community benefit obligations can easily be reduced to a specific monetary value. The Debtors may sell the Hospitals free and clear of these obligations pursuant to § 363(f)(5).

**E. Section 363(d)(1) Does Not Bar the Sale**

As noted, § 363(d)(1) provides that non-profit entities, such as the Debtors, may sell estate assets only if the sale is "in accordance with nonbankruptcy law applicable to the transfer of property by" a non-profit entity.

For the reasons discussed in Section II.B., above, the Debtors are authorized to sell the Hospitals, free and clear of the Additional Conditions, under applicable nonbankruptcy law. Even if the Debtors were not authorized to sell the Hospitals free and clear under applicable nonbankruptcy law, § 363(d)(1) does not limit the Debtors' ability to sell the Hospitals free and clear of the Additional Conditions under § 363(f)(4) or (5).[18] Basic principles of statutory construction dictate this result. "Statutory construction ... is a holistic endeavor." *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371, 108 S. Ct. 626, 630, 98 L. Ed. 2d 740 (1988). The Court must look "to the provisions of the whole law, and to its object and policy." *John Hancock Mut. Life Ins. Co. v. Harris Tr. & Sav. Bank*, 510 U.S. 86, 94–95, 114 S. Ct. 517, 523, 126 L. Ed. 2d 524 (1993). Absent a "clear intention otherwise," specific provisions addressing an issue apply instead of more generalized provisions covering the same issue. *Morton v. Mancari*, 417 U.S. 535, 550–51, 94 S. Ct. 2474, 2483, 41 L. Ed. 2d 290 (1974). This rule applies "regardless of the priority of enactment" of the provisions. *Id.*

***20** Section 363(f) sets forth specific circumstances under which assets may be sold free and clear. Section 363(f) is not limited by a non-profit debtor's general obligation under § 363(d)(1) to comply with nonbankruptcy law. The general requirement set forth in § 363(d)(1) makes no reference to § 363(f), which more specifically delineates the circumstances in which assets may be sold free and clear. Without a "clear intention otherwise," *Morton*, 417 U.S. at 550–51, 94 S.Ct. 2474, the general requirement of § 363(d)(1) does not repeal the specifics of free and clear sales under § 363(f), even though § 363(d)(1) was enacted subsequent to § 363(f).

**F. Section 541(f) Does Not Bar the Sale**

Section 541(f) provides:

> Notwithstanding any other provision of this title, property that is held by a debtor that is a corporation described in section 501(c)(3) of the Internal Revenue Code of 1986 and exempt from tax under section 501(a) of such Code may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the debtor had not filed a case under this title.

The Attorney General asserts that § 541(f)'s initial clause, "[n]otwithstanding any other provision of this title," is broad enough to trump § 363(f). According to the Attorney General, § 541(f) requires that the SGM Sale comply with applicable California law. As a result, the Attorney General argues, the SGM Sale can occur only if SGM agrees to accept all of the 2019 Conditions, including the Additional Conditions.

The language of § 541(f) is similar, but not identical to, the language of § 363(d)(1). Section 363(d)(1) requires that non-profit entities transfer property "in accordance with nonbankruptcy law applicable to the transfer of property by" the non-profit entity; § 541(f) requires that such transfers occur "only under the same conditions as would apply if the debtor had not filed a case under this title."

"[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Russello v. United States*, 464 U.S. 16, 23, 104 S. Ct. 296, 300, 78 L. Ed. 2d 17 (1983). Therefore, the Court cannot assume that § 541(f) has the same meaning as § 363(f). That is, § 541(f) cannot mean that the Debtors are required to transfer property "in accordance with nonbankruptcy law applicable to the transfer of [such] property," since that is the language used in § 363(d)(1).

There is no legislative history to guide the Court in construing the phrase "under the same conditions" in § 541(f). Nor has the Court been able to locate any cases interpreting this section. In the absence of legislative history, phrases are construed in accordance with their "ordinary or natural meaning." *F.D.I.C. v. Meyer*, 510 U.S. 471, 476, 114 S. Ct. 996, 1001, 127 L. Ed. 2d 308 (1994). According to *Roget's 21st Century Thesaurus* (3d ed. 2013), a synonymous phrase for "under the same conditions" is "in these circumstances."

Here, the Debtors have complied with § 541(f)'s mandate. That is, "[n]otwithstanding any other provisions" of the Bankruptcy Code, they have sought to transfer the Hospitals in the same manner as the transfer would have occurred under applicable nonbankruptcy law. The Debtors submitted the transfer to the review of the Attorney General, paid for the expert healthcare impact statements required under the statute, and waited for 135 days for the Attorney General to review the transaction. The transfer has been subject to the same conditions that would have applied had the Debtors not sought bankruptcy protection.

***21** Even if the Attorney General were correct that § 541(f) had the same meaning as § 363(d)(1), the Debtors would still be able to sell the Hospitals free and clear of the Additional Conditions, pursuant to § 363(f)(1), (4), and (5). Contrary to the Attorney General's contention, the "notwithstanding" clause does not mean that § 541(f) trumps § 363(f). The Ninth Circuit has held:

> In examining specific statutes, we have not, however, always accorded universal effect to the "notwithstanding" language, standing alone. *See Or. Natural Res. Council v. Thomas*, 92 F.3d 792, 796 (9th Cir.1996) ("We have repeatedly held that the phrase 'notwithstanding any other law' is not always construed literally." (citing *E.P. Paup Co. v. Dir., Office of Workers Comp. Programs*, 999 F.2d 1341, 1348 (9th Cir.1993); *Kee Leasing Co. v. McGahan (In re The Glacier Bay)*, 944 F.2d 577, 582 (9th Cir.1991); *Golden Nugget, Inc. v. Am. Stock Exch., Inc.*, 828 F.2d 586, 588–89 (9th Cir.1987) (per curium))). Instead, we have determined the reach of each such "notwithstanding" clause by taking into account the whole of the statutory context in which it appears.

*United States v. Novak*, 476 F.3d 1041, 1046 (9th Cir. 2007).

Relying upon the "common-sense principle of statutory construction that sections of a statute generally should be read to give effect, if possible, to every clause," the Ninth Circuit has held that a "notwithstanding" provision should not be given its broadest possible interpretation if doing so would render other statutory provisions ineffectual. *Oregon Nat. Res. Council v. Thomas*, 92 F.3d 792, 797 (9th Cir. 1996).

According the "notwithstanding" clause the broad construction advocated by the Attorney General would render § 363(f) of the Bankruptcy Code ineffectual with respect to non-profit debtors. Section 541(f) was added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1221(e) ("BAPCPA"). BAPCPA made no changes to § 363(f). The Court cannot find that Congress intended § 541(f) to trump § 363(f) with respect to non-profit debtors.

**G. The Court Certifies a Direct Appeal of its Decision to the Ninth Circuit Court of Appeals**

Title 28 U.S.C. § 158(d)(2) provides that the Bankruptcy Court, acting on its motion, may certify a direct appeal of an order to the Court of Appeals if the order "involves a matter of public importance" or if an immediate appeal of the order will "materially advance the progress of the case or proceeding."

Certification is warranted here. The interplay between the sale provisions of the Bankruptcy Code and the authority of the Attorney General to regulate the sale of assets subject to a charitable trust is a matter of public importance. The issue has previously arisen in *Gardens I* and *Verity I*, and will continue to arise in future cases.

A direct appeal will materially advance the progress of the case. Closing of the SGM Sale is the lynchpin of the Debtors' plan of reorganization. However, under the APA, SGM is not obligated to close the sale unless the Debtors obtain a final, non-appealable order authorizing a sale free and clear. The Debtors are facing severe liquidity constraints and cannot afford to continue to operate the Hospitals for much longer. A direct appeal will facilitate resolution of this case by providing certainty regarding the permissibility of a sale free and clear far sooner than would otherwise be possible. If the Court's order is upheld, SGM can proceed to close the sale. If not, the Debtors can commence shutting down St. Vincent, Seton, and Seton Coastside.

**III. Conclusion**

*22 Based upon the foregoing, the Court finds that the Debtors may sell the Hospitals to SGM, free and clear of the Additional Conditions. The sale may proceed under applicable nonbankruptcy law pursuant to § 363(f)(1) because (1) the Additional Conditions qualify as successor liability that may not be imposed against SGM under California law and because (2) the Attorney General abused his discretion in attempting to impose the Additional Conditions, which therefore must be set aside. A bona dispute as to the Attorney General's authority to impose the Additional Conditions exists under § 363(f)(4), because the Debtors (1) have shown that the Additional Conditions are not authorized under California law and that (2) the attempted imposition of the Additional Conditions violates § 525. Pursuant to § 363(f)(5), the sale is free and clear of the charity care and community benefit obligations, which can be reduced to a monetary valuation.

The Court will prepare and enter an order certifying this matter for a direct appeal to the Ninth Circuit. The Debtors shall submit an order granting the Motion within seven days of the issuance of this Memorandum of Decision.

**All Citations**

Slip Copy, 2019 WL 5585007

Footnotes

1 For a description of the Santa Clara Sale, see *In re Verity Health Sys. of California, Inc.*, 598 B.R. 283 (Bankr. C.D. Cal. 2018) ("*Verity I*").

2 The Approved Conditions are set forth in Schedule 8.6 of the APA.

3 For a description of the difficulties associated with closing a much smaller hospital, see *In re Gardens Reg'l Hosp. & Med. Ctr., Inc.*, 567 B.R. 820, 829 (Bankr. C.D. Cal. 2017), *appeal dismissed*, No. 2:16-BK-17463-ER, 2018 WL 1229989 (C.D. Cal. Jan. 19, 2018).

4 April 3, 2019 E-mail from Prime to the Debtors [Doc. No. 3333, Ex. 6].

5 *Id.*

6 St. Francis Conditions at § IV [Doc. No. 3188, Ex. B].

7 *Id.* at § VI.

8 *See* St. Vincent Conditions at § VI (setting forth a list of healthcare services that St. Vincent must maintain at current levels); *see also* Seton and Seton Coastside Conditions at § VI (same).

9 *See Verity I*, 598 B.R. at 293 ("The Conditions [imposed by the Attorney General] are an 'interest in property' within the meaning of § 363(f). The Conditions provide that any owner of the Hospitals must furnish specified levels of emergency services, intensive care services, cardiac services, and various other services. The required service levels were derived based upon the historical experience of the prior operator. As such, the Conditions are monetary obligations arising from the ownership of property.").

10 *See generally Verity I.*

11 *See* APA at § 1.1(a)(i) [Doc. No. 2305, Part 1].

12 As nonprofit public benefit corporations, the Debtors do not have stockholders.

13 This provision of BAPCPA does not appear in the Bankruptcy Code itself.

14 August Letter at 14.

15 *Id.*

16 SEIU-UHW contends that it is economically feasible for SGM to operate the Hospitals while complying with the Additional Conditions. The record does not support SEIU-UHW's contention. SGM was the only bidder willing to purchase the

Hospitals and has stated unequivocally that it will not complete its purchase if the Additional Conditions are imposed. These facts show that the Additional Conditions render operation of the Hospitals economically infeasible.

17 Specifically, counsel for the Attorney General explained that in imposing the conditions, the Attorney General "is weighing the impact on the affected community, and making a determination as to what would be the best outcome for this community in order to ensure that it is not being adversely impacted, and not inappropriately losing access to these nonprofit hospitals ...." Hearing Transcript [Doc. No. 3416] at 24. Counsel further stated that the Attorney General's "obligation is ... to do what's needed to preserve access to healthcare, in particular for disadvantaged populations, which is clearly what we're dealing with here." *Id.* at 12.

18 Under § 363(f)(4), the Debtors are authorized to sell the Hospitals free and clear of all of the Additional Conditions. *See* Section II.C., above. Under § 363(f)(5), the Debtors are authorized to sell the Hospitals free and clear of the charity care and community benefit obligations. *See* Section II.D., above.

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# Faculty

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