IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re	Chapter 11
SC HEALTHCARE HOLDING, LLC *et al.*,	Case No. 24-10443 (TMH)
Debtors.[1]	Jointly Administered
	Ref. Dkt. Nos. 38, 57, 73, 97

DEBTORS' REPLY REGARDING THE PRIMING DISPUTE AND IN SUPPORT OF THE DEBTORS' MOTION FOR ENTRY OF INTERIM AND FINAL ORDERS (I) AUTHORIZING THE DEBTORS TO OBTAIN POSTPETITION FINANCING, (II) GRANTING SECURITY INTERESTS AND SUPERPRIORITY ADMINISTRATIVE EXPENSE STATUS, (III) GRANTING ADEQUATE PROTECTION TO CERTAIN PREPETITION SECURED CREDIT PARTIES, (IV) MODIFYING THE AUTOMATIC STAY, (V) AUTHORIZING THE DEBTORS TO ENTER INTO AGREEMENTS WITH JMB CAPITAL PARTNERS LENDING, LLC, (VI) AUTHORIZING NON-CONSENSUAL USE OF CASH COLLATERAL, (VII) SCHEDULING A FINAL HEARING, AND (VIII) GRANTING RELATED RELIEF

The above-captioned debtors and debtors in possession (each a "Debtor" and collectively, the "Debtors") submit this reply (this "Reply") in support of the *Debtors' Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to Obtain Postpetition Financing, (II) Granting Security Interests and Superpriority Administrative Expense Status, (III) Granting Adequate Protection to Certain Prepetition Secured Credit Parties, (IV) Modifying the Automatic Stay, (V) Authorizing the Debtors to Enter Into Agreements With JMB Capital Partners Lending, LLC, (VI) Authorizing Non-Consensual Use of Cash Collateral, (VII) Scheduling a Final Hearing,*

[1] The last four digits of SC Healthcare Holding, LLC's tax identification number are 2584. The mailing address for SC Healthcare Holding, LLC is c/o Petersen Health Care Management, LLC 830 West Trailcreek Dr., Peoria, IL 61614. Due to the large number of debtors in these Chapter 11 Cases, whose cases are being jointly administered, a complete list of the Debtors and the last four digits of their federal tax identification numbers is not provided herein. A complete list of such information is available on a website of the Debtors' claims and noticing agent at https://www.kccllc.net/Petersen.

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and (VIII) Granting Related Relief [Docket No. 38] (the "Motion")[2] and in response to the objections (collectively, the "HUD Objections") filed by the Objecting HUD Lenders, Lument Real Estate Capital, LLC [D.I. 57] (the "Lument Objection") and Grandbridge Real Estate Capital LLC and Berkadia Commercial Mortgage LLC [D.I. 73] (the "Grandbridge-Berkadia Objection"). Specifically, this Reply addresses the Objecting HUD Lenders' arguments with respect to the Court's ability to the enter orders granting priming liens on real property securing loan facilities insured by the United States Department of Housing and Urban Development ("HUD") as preserved in the Interim Order (the "Priming Dispute").[3] For the reasons set forth below, the Debtors submit that the Court should resolve the Priming Dispute in favor of the Debtors, overrule the preserved HUD Objections, and grant the relief requested in the Motion.

INTRODUCTION

1. Section 364(d) of the Bankruptcy Code sets forth the requirements to obtain postpetition financing supported by a superpriority lien—which requirements the Debtors have satisfied—and contains no exception or special rules liens held or insured by the government. The Debtors therefore submit that there no conflict between the Bankruptcy Code and applicable federal housing law and regulations that would preclude the granting of superpriority liens in these Chapter 11 Cases.

2. The Objecting HUD Lenders cite no dispositive authority to the contrary, instead asserting an entitlement to a first-position liens as a matter of statutory right pursuant to the

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[2] Unless stated otherwise, capitalized terms used but not otherwise defined herein shall have the meanings ascribed to them in the Motion, the *Amended Interim Order (I) Authorizing the Debtors to Obtain Postpetition Financing, (II) Granting Security Interests and Superpriority Administrative Expense Status, (III) Granting Adequate Protection to Certain prepetition Secured Credit Parties, (IV) Modifying the Automatic Stay; (V) Authorizing the Debtors to Enter Into Agreements with JMB Capital Partners Lending, LLC, (VI) Authorizing Non-Consensual Use of Cash Collateral, (VII) Scheduling a Final Hearing, and (VIII) Granting Related Relief* [Docket No. 97](the "Interim Order"), or the HUD Objections, as applicable.

[3] Interim Order, ¶ 41.

National Housing Act, 12 U.S.C. § 1701 *et seq.* (the "NHA") and related regulations and regulatory agreements. However, the argument that the NHA "requires" the Objecting HUD Lenders to retain first-lien positions is inconsistent with long-standing principles governing the priority of interests under federal law. Similarly, the HUD Objections fundamentally misunderstand, or ignore, the well-established principles governing the treatment of federal agencies in proceedings under chapter 11 of the Bankruptcy Code. For these reasons, the Debtors submit that the Objection HUD Lenders' arguments are fatally flawed and that the Court should overrule the HUD Objections.

REPLY

I. The National Housing Act Does Not Confer Statutorily Protected First Lien Status on the Objecting HUD Lenders' Mortgages.

3. In the HUD Objections, the Objecting HUD Lenders argue that because the NHA provides that HUD-insured mortgages must be first-lien security interests, the creation of superpriority priming liens would violate their purported statutorily protected or required first-lien position. *See* Lument Objection, ¶¶ 1, 27-29; Grandbridge-Berkadia Objection, ¶¶ 2, 22. The HUD Objections base this argument on the language of 12 U.S.C. § 1715w(b)(4), which defines a "mortgage" for purposes of eligibility for insurance by HUD as a "first mortgage" or "first lien" on the property. While it is true that the NHA and implementing regulations specify that a mortgage held or insured by under the NHA should be a "first mortgage," the Objecting HUD Lenders' interpretation that they are therefore entitled to a statutorily "protected" first-lien position is based on a fundamental misunderstanding of federal law governing priorities.

4. It is a long-standing principle of federal law that, absent a statute or regulation that explicitly confers a priority position, loans held or insured by government agencies are not entitled by law to such priority. In *United States v. Kimbell Foods*, 440 U.S. 715, 99 S. Ct. 1448 (1979), the United States Supreme Court (the "Supreme Court") addressed whether state law or federal

law should govern the priority of liens where the application of the "first in time" rule potentially conflicted with state law. Rather than adopting a rule that the general federal law preempts state law or that, by analogy with tax liens, all federal liens ought to be accorded priority, the Supreme Court held that "absent a congressional directive, the relative priority of private liens and consensual liens arising from these Government lending programs is to be determined under nondiscriminatory state laws." *Id*. at 740. Consistent with *Kimbell Foods*, subsequent courts have applied state law to determine the relative priorities of private lenders and government agencies (or private lenders holding loans insured by government agencies)[4] acting as creditors in the absence of specific federal law granting governmental priority or mandating the "first in time" rule. *See United States v. Currituck Grain*, 6 F.3d 200, 206-07 (4th Cir. 1993) (collecting cases); *United States v. Gilmore*, 62 F. Supp. 2d 576, 581 (D. Conn. 1999) (same).

5. Not long after the *Kimbell Foods* decision, the First Circuit Court of Appeals addressed the implications of the Supreme Court's ruling for HUD liens. In *Chicago Title Insurance Co. v. Sherred Village Association*, 708 F.2d 804 (1st Cir. 1983), the First Circuit was faced with the question of how to apply *Kimbell Foods* in the face of potentially conflicting federal housing policy and state law. In *Chicago Title Insurance*, HUD argued that because the federal housing statute and regulations provided that HUD insure only mortgages that are "first liens" on the properties covered, "Congress has spoken regarding the priority that should be accorded a HUD insured mortgage." *Id.* at 807 (citing 12 U.S.C. § 1707(a); 24 C.F.R. §§ 203.17(a),

[4] The Objecting HUD Lenders assert that they, not HUD, are the holders of the notes or loans at issue. *See* Lument Objection, ¶ 9; Grandbridge-Berkadia Objection, ¶¶ 9, 16. As set forth in greater detail in this Reply, the Supreme Court's reasoning is *Kimbell Foods* is applied by later courts to loans insured by federal agencies held by private lenders. Accordingly, this Reply uses "HUD liens" to refer both to liens held by HUD and HUD-insured liens held by private lenders (and "HUD Liens" to refer to the Objecting HUD Lenders' liens).

207.3(a)(3)).[5] The First Circuit rejected HUD's argument and held, instead, that the statutory and regulatory provisions requiring "first lien" status for HUD loans, without an express statute or regulation altering normal priority rules, were insufficient to preempt state laws granting superpriority status to subsequently filed mechanics' liens. *Id.* at 808 ("Absent a clearer declaration by Congress or HUD, we find the agency's assumption that a federal rule of priority was necessary to ensure its "first lien" status an insufficient indication of congressional intent to render *Kimbell Foods* inapplicable."). Accordingly, notwithstanding the "first lien" and "first mortgage" language in the NHA and housing regulations, HUD loans, and other loans issued or insured by federal agencies, may be primed in the absence of legislation to the contrary.[6]

6. More recent cases have upheld this understanding of *Kimbell Foods*. For example, several district courts, applying Nevada state law conferring superpriority status on liens for unpaid homeowner association ("HOA") assessments, have held that the Nevada law is consistent with *Kimbell Foods* and provisions in the NHA requiring that a HUD mortgage be the "first lien" on the property even though foreclosure of such HOA liens by the HOA extinguishes the (now-junior) HUD lien. *See Freedom Mortg. Corp. v. Las Vegas Dev. Grp., LLC*, 106 F. Supp. 3d 1174, 1186

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[5] "Mortgage" is defined in 12 U.S.C. § 1707(a).

> (A) a first mortgage on real estate in fee simple, (B) a first mortgage on a leasehold on real estate (i) under a lease for not less than ninety-nine years which is renewable or (ii) under a lease having a period of not less than ten years to run beyond the maturity date of the mortgage, or (C) a first mortgage given to secure the unpaid purchase price of a fee interest in, or long-term leasehold interest in, real estate consisting of a one-family unit in a multifamily project.

As noted in the HUD Objections, "mortgage" is also defined as "first mortgage" in 12 U.S.C. § 1715w(b)(4). The Debtors submit that the legal reasoning applied to the mortgages subject to section 1708(a) in the cases cited herein also applies to the mortgages at issue in these Chapter 11 Cases.

[6] The Debtors submit that at least as of *Chicago Title Insurance*, if not *Kimbell Foods*, the definition of a "mortgage" as a "first mortgage" in section 1715w(b)(4) and parallel provisions of the NHA relates to the initial status of the mortgage as a first mortgage, a status which may be lost pursuant to other applicable law as elaborated in this Reply absent efforts to maintain the first-lien position. In other words, precisely because the first-lien position is not statutorily protected or required for HUD-insured loans, HUD requires, through its regulations and Regulatory Agreements, that borrowers act so as to maintain the liens as first liens.

(D. Nev. 2016) ("Allowing Nevada's HOA-lien superpriority law to extinguish a lender's first trust deed, despite the lender's participation in HUD's single-family mortgage-insurance program, is also consistent with the United States Supreme Court's decision in *United States v. Kimbell Foods, Inc.*"); *Carrington Mortg. Servs., LLC v. Tapestry at Town Ctr. Homeowners Ass'n*, 381 F. Supp. 3d 1289 (D. Nev. 2019); *Las Vegas Dev. Grp., LLC v. Yfantis*, 173 F. Supp. 3d 1046 (D. Nev. 2016). Based on the foregoing, it is clear that the words "first mortgage" or "first lien" in the NHA and related regulations do not confer a statutorily protected first-lien position that would be undermined by granting the Debtors' requested relief.[7] In fact, that HUD has promulgated regulations and includes requirements in its regulatory agreements that obligate borrowers and lenders to protect the senior position of HUD liens demonstrates that HUD itself acknowledges that provisions such as section 1715w(b)(4) of the NHA do not have the effect that the Objecting HUD Lenders claim.

7. The aforementioned cases all involved state law because *Kimbell Foods* held that state law supplied the appropriate rule "absent a congressional directive[.]" *Kimbell Foods*, 440 U.S. at 740. The HUD Objectors provide no congressional (or regulatory) directive that expressly prohibits the existence of liens senior to the HUD liens; as noted above, the courts that have addressed the issue have rejected the argument that the "first lien" or "first mortgage" requirements in the NHA and related regulations by themselves create a statutorily protected first-lien position. Moreover, to the extent that Congress and HUD have altered the statutory and regulatory landscape since the *Kimbell Foods* and *Chicago Title Insurance* decisions, they have not done so in a way that evinces a desire to impose a strict requirement of priority for HUD liens:

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[7] *See, e.g., In re Bucyrus Cmty. Hosp., Inc.*, Nos. 10-61078, 10-61081, 2010 Bankr. LEXIS 6165, at *6 (Bankr. N.D. Ohio June 18, 2010) (granting superpriority lien in accounts receivable to DIP lender over objection of HUD-insured mortgagee asserting first lien in accounts receivable). The court in *Bucyrus Community Hospital*, however, does not articulate the reasoning underlying its ruling in its order.

a. Changes to Housing Laws and Regulations. After the *Kimbell Foods* decision, Congress passed the Multifamily Mortgage Foreclosure Act, 12 U.S.C. § 3701 *et seq.* (the "MMFA"), which, *inter alia*, sets forth the priority distribution for foreclosures undertaken by HUD. 12 U.S.C. § 3712. In addition, after *Chicago Title Insurance*, HUD enacted 24 C.F.R. § 27.40(a), which provides that in foreclosures pursuant to the MMFA, "[t]he priority of the Secretary's lien shall be determined by the Federal first-in-time first-in-right rule" and that "[s]tate laws affording priority to liens recorded after the mortgage are preempted." However, neither 12 U.S.C. § 3712 nor 24 C.F.R. § 27.40(a) provides that HUD liens must have absolute priority. And, importantly, 12 U.S.C. § 3712 and 24 C.F.R. § 27.40(a) apply only to security interests held by HUD and not to HUD-insured security interests of private lenders. [8]

b. Changes to the Bankruptcy Code. The Bankruptcy Code provides that the Court may authorize postpetition financing that may result in the priming of an existing security interest so long as the Debtors are unable to obtain such credit otherwise and the security interest that will be primed will be adequately protected. 11 U.S.C. § 364(d)(1). Congress has not expressly limited the ability of a trustee of debtor in possession to prime security interests granted to or insured by federal agencies, including HUD, even though Congress is quite capable of creating—and has created—exceptions for HUD or other government agencies. *See, e.g.*, *id.* § 362(b)(8) (excepting from automatic stay the commencement of foreclosure actions *by the Secretary of HUD*—i.e., not private lenders—

[8] The MMFA defines a "multifamily mortgage" as "a mortgage held by the Secretary…" 12 U.S.C. § 3702(2). As noted above, the Objecting HUD Lenders assert that they, not HUD, are the holders of the notes or loans at issue. Given that each Objecting HUD Lender "has additional protection for repayment of its loans through HUD's insurance of the loans in accordance with the National Housing Act," Lument Objection, ¶ 7, private holders of HUD-insured loans face less risk.

> "in any case in which the mortgage or deed of trust held by the Secretary is insured or was formerly insured under the National Housing Act and covers property, or combinations of property, consisting of five or more living units").

In *Kimbell Foods*, the Supreme Court, noting that amendments to the Federal Tax Lien Act of 1966, 26 U.S.C. § 6323, permitted more state claims to have priority over federal tax liens demonstrated "Congress' disapproval of unrestricted federal priority in an area as important to the Nation's stability as taxation," concluded that such legislation "provide[d] further evidence that treating the United States like any other lender would not undermine federal interests."). *Kimbell Foods*, 440 U.S. at 738. The Debtors submit that the legislative and regulatory response of Congress and HUD demonstrate that the statutory and regulatory framework on which *Kimbell Foods* and *Chicago Title Insurance* were based has not been altered with respect to private HUD-insured lenders so as to create a statutorily protected senior lien position that, on that basis, ought not be subject to priming.

8. "[W]hen two statutes are capable of coexistence, it is the duty of the courts, absent clearly expressed congressional intention to the contrary, to regard each as effective." *Rowland v. Bissell Homecare, Inc.*, 73 F.4th 177, 183-84 (3d Cir. 2022) (quoting *J.E.M. Ag Supply, Inc. v. Pioneer Hi-Bred Int'l, Inc.*, 534 U.S. 124, 143–44 (2001)). The Debtors submit that in light of *Kimbell Foods*, *Chicago Title Insurance*, and subsequent legislative and regulatory history, the proper effect of 12 U.S.C. § 1715w(b)(4) is *not* to confer a statutorily protected first-lien position such that priming the HUD Liens would constitute a "violation" of the NHA .

9. Based on the foregoing, to the extent that there are any limitations on the priming of the HUD Liens, they are to be found in the HUD regulations and Regulatory Agreements. As

explained in greater detail below, however, the HUD regulations and Regulatory Agreements do not preclude the Court from authorizing the proposed priming of the HUD Liens.

II. The Regulatory Agreements Do Not Bar the Priming of the HUD Liens.

10. In addition to the erroneous argument that the NHA confers a statutorily protected first-lien status on their security interests, the Objecting HUD Lenders contend that because HUD regulations and the Regulatory Agreements require the maintenance of the HUD liens as first liens and require HUD's consent to further encumbrances, the Regulatory Agreements preclude the granting of superpriority liens pursuant to section 364(d) of the Bankruptcy Code. *See* Lument Objection, ¶ 29.

11. This argument fails for two reasons. *First*, under longstanding principles of law, the economic claims of federal agencies as lenders and insurers are treated like the claims of other creditors and are subject to the provisions of the Bankruptcy Code governing the nonconsensual cram-down of claims or use of property subject to a prepetition security interest. *Second*, even if the Court treats the relevant HUD regulations and provisions of the Regulatory Agreements as advancing HUD's public policy rather than purely its financial or fiscal concerns, the Court has the authority to balance the goals of federal housing policy and chapter 11 of the Bankruptcy Code in deciding whether to allow the Debtors to prime the HUD liens, and the appropriate balancing weighs in favor of granting the relief requested in the Motion.

A. HUD and the Objecting HUD Lenders Are Subject to the Bankruptcy Code as Secured Creditors.

12. As discussed above, under *Kimbell Foods* and subsequent decision, the "first lien" and "first mortgage" language in federal housing statutes do not take the place of explicitly legislation providing for statutorily protected first-lien status, and further encumbrance of a property subject to a HUD lien is not a "violation" of the NHA. The Supreme Court also reached

another conclusion in *Kimbell Foods* that is fatal to Objecting HUD Lenders' position: federal agencies, in their capacity as lenders, are just like other economic actors. Specifically, the Supreme Court reasoned that special priority rules for agencies in their capacities as lenders were unnecessary because:

> [t]he Government … is in substantially the same position as private lenders, and the special status it seeks is unnecessary to safeguard the public fisc. Moreover, Congress' admonitions to extend loans judiciously supports the view that it did not intend to confer special privileges on agencies that enter the commercial field. Accordingly, we agree with the Court of Appeals in No. 77-1359 that "[as] a quasi-commercial lender, [the Government] does not require . . . the special priority which it compels as sovereign" in its tax-collecting capacity.

Kimbell Foods, 440 U.S. at 737-38 (1979) (quoting *Kimbell Foods, Inc. v. Republic Nat'l Bank of Dallas*, 557 F.2d 491, at 500 (5th Cir. 1977) (brackets in original). Put differently, the significance of the Supreme Court's holding in *Kimbell Foods* is that, absent explicit statutory or regulatory directives, "federal lending agencies are clearly governed by the same rules which control the rights and duties of private secured parties. With respect to filing and perfection, priorities, and default provisions, federal agencies will be measured by the same standards as commercial banks, credit unions, finance companies, and credit sellers." *United States v. Cent. Livestock Corp.*, 616 F. Supp. 629, 632 (D. Kan. 1985) (quoting Barkley Clark, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE, para. 1.8[1][g] (1980)).

13. Consistent with this understanding of *Kimbell Foods*, bankruptcy courts have treated the interests of HUD in its capacity as lender or insurer like the interests of other creditors in a bankruptcy proceeding. And where appropriate, courts have permitted the impairment of HUD's claims notwithstanding provisions in regulatory agreements ostensibly intended to limit such impairment. For example, in *In re Water Gap Village*, the New Jersey bankruptcy court held that, in HUD's capacity as a creditor in a bankruptcy, HUD's claim was subject to cram-down

under a chapter 11 plan just like the claims of other creditors, and confirmed a plan over HUD's objection that the certain plan provisions usurped HUD's regulatory authority. *In re Water Gap Vill.*, 59 B.R. 23, 27 (Bankr. D.N.J. 1985). Specifically, noting that "HUD regulates its lending, financing and insuring … in the interest of fiscal prudence and to protect its financial position," the court concluded that HUD "cannot be solely in the business of regulating" such that its regulatory authority ought to trump the debtor's ability to reorganize. *Id.* Rather, "HUD's status [in the bankruptcy case] is that of government agency *qua* secured creditor," and therefore, "HUD can be subject to the jurisdiction of the Code including, *inter alia*, the Section 1129 'cram-down' authority of this Court to confirm the Plan over its objection." *Id.*

14. Similarly, in *Beal Bank, S.S.B. v. Way Apartments (In re Way Apartments)*, 201 B.R. 444 (N.D. Tex. 1996), the Texas district court affirmed the bankruptcy court's confirmation of a debtor's chapter 11 plan over HUD's objection. Notably, the plan classified HUD's claim separately from the claims of other unsecured creditors due to HUD's distinct interests as a creditor under the NHA. *Id.* at 451. The district court (and bankruptcy court) permitted this classification as a proper exercise of the "good business reason" exception to the general rule against separating unsecured creditors into different classes. *Id*. As in *In re Water Gap Village*, however, HUD was treated like other creditors in the case, and because another class of impaired creditors had voted in support of the plan, the plan was confirmed pursuant to section 1129 of Bankruptcy Code and the court's cram-down authority. *Id.* at 449.

15. Likewise, in *In re Executive House Associates*, HUD sought relief from the automatic stay and objected to the debtor's chapter 11 plan of reorganization, arguing, *inter alia*, that a plan provision permitting the nonconsensual use of HUD's cash collateral impermissibly violated the applicable regulatory agreement, thereby making the plan unconfirmable. The court

denied HUD's motion for relief from the automatic stay and rejected the argument that the regulatory agreement precluded the debtor's nonconsensual use of cash collateral, holding instead that HUD's cash collateral may be used if HUD is adequately protected. *In re Exec. House Assocs.*, Bankruptcy No. 88-10214F Chapter 11, 1989 Bankr. LEXIS 2757, at *19-20 (Bankr. E.D. Pa. July 6, 1989). After an extensive review of the plan's provisions regarding the debtor's proposed adequate protection, the court concluded:

> [W]ith relatively minor modifications or clarifications, the debtor's third amended plan proposes to repay HUD's allowed secured claim in a manner consistent with the minimum requirements of the code, at an interest rate sufficient to compensate HUD for the risk that the plan will not be consummated or that its collateral will depreciate, with sufficient restrictions to adequately protect HUD for the use of its collateral, and which justifies the debtor's continued use of collateral and recovery of any appreciation which might occur….

Id. at *25. In *In re Executive House Associates*, the court permitted the nonconsensual use of cash collateral pursuant to section 363(e) of the Bankruptcy Code despite HUD's argument that non-consensual use of cash collateral was prohibited by the regulatory agreement. Much like section 363(e) provides for the nonconsensual use of cash collateral so long as the cash collateral is adequately protected, section 364(d) provides for the nonconsensual priming of security interests so long as the security interests are adequately protected. Neither section 363(e) nor section 364(d) contains any exception for federal agencies acting as secured creditors. Accordingly, just as a court may permit the nonconsensual use of cash collateral if HUD's cash collateral will be adequately protected pursuant to section 363(e), section 364(d) permits the Debtors to prime the HUD Lien upon establishing that the HUD Liens are adequately protected.

16. The Debtors acknowledge that there is an exception to the principle that HUD is treated like other creditors under the Bankruptcy Code: when HUD regulations or provisions in regulatory agreements serve a public interest independent of HUD's financial or fiscal interests as a creditor, bankruptcy courts are more likely to find that the Bankruptcy Code does not preempt

such regulatory directives. For example, in *In re Welker*, the court granted a chapter 7 trustee's motion to sell property pursuant to section 363 of the Bankruptcy Code, but conditioned the sale on the trustee's compliance with certain HUD requirements. *In re Welker*, 163 B.R. 488, 489 (Bankr. N.D. Tex. 1994) ("[t]he Bankruptcy Code does not authorize the court to employ § 363 to supersede or preempt [HUD guidelines] or the compelling public policy interests behind the housing acts."). But in *In re Welker*, the requirements at issue related to the property's status as a low-income housing project, and the court held that the chapter 7 trustee could sell the property free and clear of HUD's lien (i.e., its financial interest) but not free and clear of the regulatory requirements in the debtor's agreement with HUD that were squarely intended to advance public policy goals. *Id. See also In re Clifton Terrace Apartments*, Case No. 95-1095, Chapter 11, 1996 Bankr. LEXIS 852 (Bankr. D.D.C. May 13, 1996) (granting HUD's motion for relief from the automatic stay where debtor was in default of regulatory agreement imposing maintenance standards on subsidized housing project).

17. Here, as in *In re Water Gap Village*, *Beal Bank* and *In re Executive House Associates*, the provisions in the Regulatory Agreements that form the basis of the HUD Objections overwhelmingly implicate HUD's financial interests as creditor and insurer rather than its interest as a regulator advancing public policy objectives such as the maintenance of quality standards at the Debtors' facilities. Accordingly, the Debtors submit that just as previous courts have treated HUD's claims arising from the financial terms of regulatory agreements as creditor claims by permitting cram-down of HUD liens and non-consensual use of HUD's cash collateral, so too may the Court authorize the priming of the HUD Liens in these Chapter 11 Cases.

B. The Court May Balance the Interests of Federal Housing Policy and the Bankruptcy Code to Permit Priming.

18. Even if the relevant regulations and provisions in the Regulatory Agreements are treated as furthering HUD's public policy objectives as regulator rather than HUD's position as a creditor, it is well-established that "[w]hen confronted with two different statutory schemes, the court must attempt to harmonize the goals and policies of each." *In re Cap. W. Invs.*, 186 B.R. 497, 499 (N.D. Cal. 1995) (citing *Nat'l Lab. Rels. Bd. v. Bildisco*, 465 U.S. 513 (1984)). The required harmonization of these goals and policies may result in the modification of the provisions of a regulatory agreement, and Debtors submit that limited modification would be appropriate in these Chapter 11 Cases.

19. For example, in *In re Andover Senior Care, LLC*, HUD argued that certain obligations and rights in the relevant regulatory agreements had to be incorporated into the debtor's plan and could not be extinguished or modified by the debtor. The debtor, operator of several residential health care facilities, argued that HUD, a government agency with the status of a secured creditor, was subject to the bankruptcy court's authority to cram down a debtor's plan under section 1129. The court took the view that "it has discretion to evaluate the regulatory requirements in the context of confirmation" of the debtor's plan, and could "balance[] the equities when weighing the regulatory requirements and public policy of the § 232 program of the National Housing Act against the goals and public policy of the Bankruptcy Code and a Chapter 11 reorganization." *In re Andover Senior Care, LLC*, No. 22-10139, 2023 Bankr. LEXIS 1968, at *8 (Bankr. D. Kan. Aug. 3, 2023) (citing *In re Water Gap Village* and *In re Capital W. Investors.*). After reviewing various provisions of the applicable regulatory agreements and the debtor's proposed plan, the court modified certain terms of the regulatory agreements as part of the order of confirmation, including adding protections for the debtor to the procedures in the regulatory

agreement that permitted HUD to replace the debtor as operator of the facilities. *In re Andover Senior Care, LLC*, No. 22-10139, 2023 Bankr. LEXIS 1968, at *21-22.

20. Here, to the extent there is a conflict between the Debtors' request for authority under the Bankruptcy Code to prime the HUD Liens and the NHA, the Debtors submit that the balance of equities weighs in favor of the Debtors for several reasons. *First*, as noted above, *Kimbell Foods* and subsequent cases such as *Chicago Title Insurance* and *Freedom Mortgage* are clear: absent an explicit legislative or regulatory directive to the contrary, maintenance of a senior lien position for government lenders or government-insured private lenders is not an overarching public policy goal. In these Chapter 11 Cases, the Debtors seek to prime the HUD Liens in accordance with section 364(d) of the Bankruptcy Code, which permits such priming provided that the HUD Liens are adequately protected. Accordingly, there is no direct conflict between federal housing policy and the statutory imposition of superpriority liens pursuant to the Bankruptcy Code.

21. *Second*, the Debtors do not seek to indiscriminately excise inconvenient requirements of the regulatory agreements, but only, consistent with the Bankruptcy Code and findings of the Court, to obtain limited priming of the HUD Liens. *Compare In re Cap. W. Invs.*, 186 B.R. at 500 (ruling that bankruptcy court improperly balanced NHA and the Bankruptcy Code by confirming plan that completely eliminated provisions of regulatory agreement) *with In re Exec. House Assocs.*, Bankruptcy No. 88-10214F Chapter 11, 1989 Bankr. LEXIS 2757, at *25 (permitting confirmation over HUD's objection upon implementation of modifications to plan that would adequately protect HUD's collateral). Because the Debtors may only prime the HUD Liens if the HUD Liens are adequately protected, a burden which the Debtors must otherwise meet, the Debtors' proposed postpetition financing in these Chapter 11 Cases is unlike the debtor's chapter 11 plan in *Capital W. Investors*.

22. *Third*, the relevant provisions of the regulatory agreements, construed as reflecting public policy concerns rather than purely financial concerns of HUD as a creditor, may be seen as furthering the public policy of making housing available and affordable by reducing risk and uncertainty for mortgage lenders. *See, e.g.*, *In re Cap. W. Invs.*, 186 B.R. at 500 (noting, *inter alia*, that "[i]f HUD guarantees can be easily circumvented through bankruptcy, banks will be more likely to require larger downpayments or charge higher interest rates for mortgages, in direct contravention of the purpose behind the National Housing Act."). In a similar vein, the Objecting HUD Lenders argue that "if the [Grandbridge and Berkadia] Prepetition Liens are primed, in violation of the respective HUD Regulatory Agreements and the NHA, HUD can refuse to permit assignment of the HUD loans. The loss of assignability is not only a risk for the Lenders but is also inconsistent with the Debtors' professed goal to maximize value for the estates." Grandbridge-Berkadia Objection, ¶ 23.

23. While such concerns are understandable, courts do not consistently treat them as dispositive. In *Chicago Title Insurance*, HUD similarly argued that permitting subsequently filed mechanics' liens to have a superpriority position over HUD-insured liens would have a number of negative effects, including that: (1) "title insurance companies will be unwilling to write lien coverage for HUD projects in states like Maine [that granted such priority]"; (2) "initiating lenders and subsequent purchasers of the mortgages will be unwilling to assume the risk of having their mortgages 'primed' by (i.e., subordinated to) subsequently recorded mechanics' liens"; and (3) "HUD projects will come to a halt in those states and there will be no more federally insured low and moderate income housing there." *Chicago Title Ins. Co.*, 708 F.2d at 811. The First Circuit affirmed the district court's rejection of these consequentialist arguments, noting that the evidence did not suggest that the predicted negative consequences would come to pass, and that

other avenues (such as mechanics' lien insurance coverage) existed for HUD-insured lenders to protect their interests. *Id*. The Debtors submit that in these Chapter 11 Cases, the Bankruptcy Code itself creates such an avenue for mitigating the risks that come with the priming of a senior lien by mandating a showing of adequate protection before permitting the granting of priming liens.

24. In addition, with respect to the specific concern raised in the the Grandbridge-Berkadia Objection, the Debtors note that the Objecting HUD Lenders do not cite any statutory or regulatory basis for the concern that HUD would prevent assignment under these circumstances, nor does it offer any support for its assertion that granting the Debtors' request to prime the HUD Liens "may cause HUD to reject any claim to recover losses under the loans through the HUD insurance program." Grandbridge-Berkadia Objection, ¶ 2. The HUD Section 232 Handbook provides that in the event of a borrower bankruptcy, "[u]ntil an FHA insurance claim is filed, HUD expects the Mortgagee/Servicer to fully participate in the bankruptcy proceedings" and that "to guard HUD's interests and keep HUD fully informed as to the case's progress and major developments." HUD Section 232 Handbook Section 3.10.14.C.1, *available at* https://www.hud.gov/sites/documents/42321HSGH.PDF. There is no indication that HUD is likely to deny a mortgagee's claim when the mortgagee fulfills its duty but the court nevertheless rules against the mortgagee or that a mortgagee that is concerned about the position of its claim such circumstances as exist in these Chapter 11 Cases may not file an insurance claim.

25. "Priming is extraordinary relief." *In re LTAP US, LLLP,* 2011 WL 671761, *3 (Bankr. D. Del. Feb. 18, 2011). But whether such relief should be granted in these Chapter 11 Cases should be based on whether the Debtors have made the required "strong showing that the loan to be subordinated is adequately protected." *Id.* Objecting HUD Lenders assert that they

have statutorily protected first-lien status based on a misunderstanding of the relevant provisions of the NHA that disregards longstanding precedents that directly address the priorities accorded to federal lending agencies and federally-insured lenders and the relationship between federal housing policy and chapter 11 of the Bankruptcy Code. This erroneous assertion should not, on its own, strip the Court of its ability to assess the evidence and make a determination, consistent with its authority under section 364(d) of the Bankruptcy Code, whether the Objecting HUD Lenders are adequately protected and, therefore, the HUD Liens can be primed on the terms proposed.

[Remainder of page intentionally left blank]

CONCLUSION

For the reasons stated above, the Debtors submit that the Court should resolve the Priming Dispute in the Debtors' favor by overruling the HUD Objections and granting the relief requested in the Motion and such other and further relief as may be just and proper.

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