IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
SC HEALTHCARE HOLDING, LLC, *et al.*,[1]	Case No. 24-10443 (TMH)
Debtors.	(Jointly Administered)
	Ref. Docket Nos. 38, 57, 73 & 91

JOINT OBJECTION OF HUD LENDERS TO 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

Grandbridge Real Estate Capital LLC ("Grandbridge"), Berkadia Commercial Mortgage LLC ("Berkadia" and together with Grandbridge, the "Grandbridge & Berkadia Lenders"), Lument Real Estate Capital LLC ("Lument"), and Wells Fargo Bank, N.A. ("Wells Fargo" and, collectively with the Grandbridge & Berkadia Lenders and Lument, the "HUD Lenders"), each HUD-insured lenders to certain Debtors, hereby file this objection (this "Objection") to *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*

[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, for which the Debtors have requested joint administration, 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 will be made available on a website of the Debtors' proposed claims and noticing agent at www.kccllc.net/Petersen.

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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. 38] (the "DIP Motion"). In support of this Objection, the HUD Lenders fully incorporate by reference the *Objection of Grandbridge Real Estate Capital LLC and Berkadia Commercial Mortgage LLC to Debtors' DIP Motion and Joinder to Lument Real Estate Capital LLC's Objection to DIP Motion* [Docket No. 73], and the *Objection of Lument Real Estate Capital LLC to 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 Parties, (IV) Modifying the Automatic Stay, (V) Authorizing the Debtors to Enter into Agreements with JMB Capital Partners Lending, LLC, (VI) Authorizing NonConsensual Use of Cash Collateral, (VII) Scheduling a Final Hearing, and (VIII) Granting Related Relief* [Docket No. 57] (collectively, the "Initial Objections")[2] and further respectfully state as follows:

PRELIMINARY STATEMENT

1. Pursuant to the DIP Motion, the Debtors seek authority under Bankruptcy Code Section 364(d) to obtain a $45 million DIP financing loan with a 12% non-default interest rate and, among other fees, a 2% up front fee and an 8% Exit Fee. The Debtors concede that as of the Petition Date substantially all of their assets were encumbered by secured debt, with numerous separate lenders having mortgage liens and security interests on various facilities the Debtors operate.

[2] Capitalized terms used herein but otherwise not defined shall have the meanings ascribed to such terms in the DIP Motion or Initial Objections, as applicable.

2. The proposed DIP financing seeks to prime the HUD Lenders' prepetition first-priority secured loans in a request by the Debtors that, as originally requested in the DIP Motion, would effectively invalidate the statutory requirements of the National Housing Act. The HUD Lenders understand that the Debtors have since reached agreement with the U.S. Department of Housing and Urban Development ("HUD") to exclude from the priming liens some, but not all, of the HUD Lenders' collateral. While the HUD Lenders expect that agreement will obviate the need to litigate the HUD lien priming matters addressed by the Debtors in their *Reply Regarding the Priming Dispute and in Support of the Debtors' DIP Motion* (the "Reply") [Doc. 129], and by the HUD Lenders in paragraphs 3 through 6 and 21 through 35 of this Objection, the HUD Lenders address those matters in this Objection in the unlikely event that they remain live issues to be decided by the Court at the final hearing on the DIP Motion.

3. The HUD Lenders hold loans that are insured by HUD pursuant to the National Housing Act ("FHA Insurance"). Under the program, HUD lenders apply to HUD for their loans to a borrower to be part of the FHA Insurance program in exchange for the HUD lender's and borrower's agreement to follow HUD's regulations and requirements. Borrowers—such as the HUD Debtors[3]—benefit from the FHA Insurance program by receiving below-market interest rate loans. As discussed below, to obtain and maintain the FHA Insurance, HUD regulations require that the HUD Lenders' liens remain first liens on the mortgaged facility.

4. Debtors' DIP Motion not only ignores the fact that the FHA Insurance program does not permit any loan to prime the HUD insured mortgage, the case law cited by

[3] As used herein, the HUD Debtors refer to Petersen Health Care – Illini, LLC; Petersen Roseville, LLC; Petersen 23 LLC; Petersen 26 LLC; Petersen 27 LLC; Petersen 29 LLC Petersen 30 LLC; South Elgin, LLC; Jonesboro, LLC; Macomb, LLC; Petersen Roseville, LLC; and SJL Health Systems, Inc., Debtors who are Borrowers of the appliable HUD Lender and who own real estate subject to the existing a first-priority lien in favor of the applicable HUD Lender.

Debtors in support of their position is inapposite to their ability to obtain such relief. Each case cited by the Debtors in their Reply deals with ascertaining the existing priority of HUD liens, not the creation of new priming liens. Here, it is undisputed that the HUD Lenders hold first priority mortgage liens and security interests in the HUD Debtors' (and affiliated master tenant and operator Debtors') real estate and personal property, as required by HUD and consistent with Illinois state law. Thus, case law dealing with priority generally is irrelevant to this Court's consideration of the issues before it.

5. Additionally, circumventing the National Housing Act would frustrate the purpose behind mortgage insurance for nursing homes and related facilities and could have staggering long-term ramifications for the future of HUD-insured lending. Should the Court grant the DIP Motion, it would set precedent to allow borrowers to avoid HUD requirements simply by filing for bankruptcy. That precedent would, in turn, have a chilling effect on the ability and willingness of HUD Lenders to continue financing health care facilities like those operated by the Debtors, as well as HUD's willingness to insure loans due to the increased risk of loss posed by priming the priority of mortgages securing insured loans. Facilities that are financed by HUD-insured loans provide health care and nursing services to hundreds of thousands of residents through the United States. Financing for those facilities will be placed in serious doubt going forward if this Court eviscerates this key provision of the National Housing Act.

6. Notwithstanding the lack of legal authority supporting the creation of priming liens in contravention of the National Housing Act and the potentially devastating systemic effects that would flow from ignoring the statutory requirements, the Debtors proposed just such a financing by asking the Court to allow the DIP Lender to prime the HUD Lenders, with

no prior effort made to structure the DIP lending facility in a way that preserves the HUD insurance and complies with the FHA Insurance program requirements.

7. Moreover, on May 7, the Debtors circulated to the HUD Lenders a revised proposed draft final order on the DIP Motion (the "Proposed Final Order") which contains a death-trap for Prepetition Secured Parties that do not consent to the Proposed Final DIP Order and, for those objecting lenders, deletes substantially all of the "adequate protection" originally proposed by the Debtors in the DIP Motion.

8. The Debtors' proposed DIP financing fails to provide the HUD Lenders with adequate protection that provides the HUD Lenders with the indubitable equivalent of the interests in property that they stand to lose by virtue of the priming liens. Despite having the burden of proving that under Section 364(d)(1)(B) there is adequate protection of the HUD Lenders' blanket lien on the assets of the relevant Debtors, the DIP Motion (and related documents) contain no reliable evidence. Instead, the DIP Motion and Proposed Final Order would diminish or eliminate value that the HUD Lenders would otherwise be entitled to receive as first-priority lienholders and propose replacement liens only in the very same collateral on which the HUD Lenders already hold a lien. Even then, under the Proposed Final Order, such replacement liens are to be subordinated to:

a. the Carve-Out;

b. DIP Loan obligations;

c. the allocated, uncapped costs of these cases (which are inflated for non-consenting Prepetition Secured Parties to include an outsized portion of the DIP Lender's Exit Fee), effectively giving a blank check to the estates and to all Debtor and Committee professionals; and

d. adequate protection liens of all consenting Prepetition Secured Parties.

9. While the Debtors have finally offered valuation testimony, via a declaration of Mark Myers purporting to show that as of the Petition Date the value of each HUD Lender's collateral exceeded its loan balance, because of the deeply subordinated nature of the replacement liens proposed for objecting lenders, the Debtors offer no evidence that such replacement liens have any value at all, let alone value that is the indubitable equivalent of the HUD lenders' existing liens.

10. In addition to the Debtors' lack of evidence of adequate protection, the relief sought in the DIP Motion, as supplemented in the proposed Final Order, suffers from a number of other critical defects as discussed herein.

BACKGROUND[4]

11. On March 20, 2024 (the "Petition Date"), Debtors filed voluntary petitions for relief under title 11 of the United States Code, 11 U.S.C. §§ 101–1532 (the "Bankruptcy Code") in the United States Bankruptcy Court for the District of Delaware (the "Court"). On the Petition Date, the Debtors filed the DIP Motion.

12. On March 21 and 22, 2024, Lument and the Grandbridge & Berkadia Lenders, respectively, filed the Initial Objections objecting to the relief sought in the DIP Motion on an interim basis.

13. On March 22, 2024, the Court held a "first day hearing" on, among other pleadings, the DIP Motion. At that hearing, the HUD Lenders asserted the objections stated in the Initial Objections, and the Debtors and HUD Lenders agreed to certain revisions to the proposed

[4] The factual background related to the HUD Lenders' Prepetition Liens is set forth in detail in the Initial Objections and is not repeated herein. The HUD Lenders fully incorporate by reference the factual background set forth in the Initial Objections in this Objection.

interim order to preserve the issues raised in the HUD Lenders' Initial Objections for a final hearing on the DIP Motion.

14. On March 24, 2024, the Court entered the *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. 91] (the "Interim Order").

15. On May 7, 2024 the Debtors circulated to the HUD Lenders their revised Proposed Final Order approving the DIP Motion on a final basis, which would effectively nullify the already-deficient "adequate protection" afforded to non-consenting lenders by the Interim Order.

16. For Consenting Prepetition Lenders, the Debtors proposed that such lenders be granted, as adequate protection, (a) priming liens on all of the Debtors' assets, including the HUD Debtors, except a narrow category of assets referred to as the "Excluded HUD Mortgage Collateral"[5]; and (b) superpriority claims against the estates of all Debtors, including HUD Debtors.

5 The Debtors have agreed to exclude from the DIP Lender's priming lien only the "'real property' portion of the HUD Lenders' collateral, with real property defined specifically to be the ground, buildings, fixtures (as defined in Article 9, § 102 of the UCC) , together with, in each case related thereto, (i) claims under any real property insurance and the proceeds thereof, (ii) condemnation claims, awards and proceeds; and (iii) any funds held by HUD Lenders in escrow or reserves relating to such real property or loan secured thereby" (the "Excluded HUD Mortgage Collateral"). Proposed Final Order, Para 11(c). Debtors propose to continue to seek to prime many things that are subject to the HUD Lender's prepetition liens by providing that "For the avoidance of doubt, the Excluded HUD Mortgage Collateral does not include accounts, contract rights, chattel paper, cash (to the extent such cash is not Reserves or proceeds of any other Excluded HUD Mortgage Collateral), general intangibles, machinery, equipment, goods, inventory, furniture, letter of credit rights, books and records, deposit accounts, documents, instruments, commercial

17. For the objecting HUD Lenders, on the other hand, the Debtors proposed a "death trap" package that would:

a. Subordinate the HUD Lenders' prepetition claims and liens on all of their collateral except the Excluded HUD Mortgage Collateral to (i) the Carve Out, (ii) over $53 million in DIP Liens, and (iii) the adequate protection superpriority claims and liens of all Consenting Prepetition Secured Parties.

b. Limit each HUD Lender's 507(b) adequate protection claim to the particular Debtor against which such HUD Lender had a prepetition secured claim;

c. Limit each HUD Lender's replacement lien to the particular collateral that secured such HUD Lender's prepetition lien.

18. To complete the trap, the Debtors proposed to waive marshaling as it relates to the DIP Lender and the Prepetition Secured Parties, so that the claims of those parties could be paid first from the HUD Lenders' collateral without challenge.

19. Thus, the Debtors are proposing to funnel all of the HUD Lenders' collateral (except the limited pool of Excluded Collateral) to estate professionals, the DIP Lender and other Prepetition Secured Parties, and giving nothing of any ascertainable value to the HUD Lenders in the way of adequate protection for that diminution.

OBJECTION

20. The DIP Motion should be denied for all of the reasons stated in the Initial Objections, and for the reasons discussed below. As noted above, the HUD Lenders believe that the issued addressed in Sections A and B below have been resolved by the Debtors' agreement to

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tort claims, leases and leaseholds and rents, or the going concern value of any of the Debtors' business operations, including any government issued licenses issued in connection with the operations of the Debtors' business." Id.

make changes to the proposed Final DIP Order requested by HUD, and are addressed here only in case that agreement is for any reason abrogated.

A. The National Housing Act Requires FHA and HUD Loans To Be The First Mortgage.

21. The National Housing Act specifically allows for FHA Insurance for nursing homes, assisted living facilities, and other intermediate care facilities. 12 U.S.C. § 1715w(a)(1). These loans are referred to as Section 232 loans. FHA Insurance provides lenders with protection against losses from a default, and those loans bear less risk because the FHA will pay a claim to the lender in the event of a default. The loans must meet certain statutory requirements established by the National Housing Act and the regulations promulgated by HUD thereunder (the "HUD Regulations") to qualify. In exchange for these protections against default, lenders understand that they forego higher potential returns that could be realized if they deployed their resources in non-insured contexts, and subject themselves to additional regulatory obligations mandated by HUD.

22. In particular, the National Housing Act requires, among other things, that the mortgage to be insured be executed by a borrower approved by HUD, that it not exceed established loan to value percentages, and that the mortgage be a "***first*** mortgage on real estate in fee simple." 12 U.S.C. § 1715w(b)(4) (emphasis added).

23. Section 1715w defines "first mortgage" as "classes of first liens as are commonly given to secure advances (including but not limited to advances during construction) on, or the unpaid purchase price of, real estate under the laws of the State in which the real estate

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is located." 12 U.S.C. § 1715w(b)(4). Accordingly, the National Housing Act looks to state law – in this case Illinois – for the determination of whether the mortgage is a "first mortgage."

24. Under Illinois law, "[t]he general rule with recorded liens, including mortgages, is that '[a] lien that is [recorded] first in time *** has priority and is entitled to prior satisfaction of the property it binds.'" *Union Planters Bank, N.A. v. FT Mortg. Cos.*, 794 N.E.2d 360, 363 (Ill. Ct. App. 2003) (quoting *Aames Capital Corp. v. Interstate Bank of Oak Forest*, 734 N.E.2d 493, 496 (Ill. Ct. App. 2000)). "A presumption exists that the first mortgage recorded has priority." *Fannie Mae v. Kuipers*, 732 N.E.2d 723, 726 (Ill. Ct. App. 2000) (citing *Firstmark Standard Life Insurance Co. v. Superior Bank FSB*, 271 Ill. App.3d 435, 649 N.E.2d 465 (Ill. Ct. App. 1995)). Accordingly, only certain liens are granted super priority over a properly recorded mortgage. *See*, *e.g.*, *LaSalle Bank Nat'l Ass'n v. Cypress Creek 1, LP*, 950 N.E.2d 1109, 1116-17 (Ill. 2011) (finding that Illinois' mechanics lien statute "gives lienholders priority only with respect to the added value of the property attributable to those improvements forming the basis for the lien in question and gives the mortgagee priority with respect to the value of the land at the time the contract is entered into between the owner and the contractor."); 65 ILCS 5/11-31-1 (granting super priority lien for certain costs incurred by municipalities); 35 ILCS 200/21-75 (granting tax liens that are "superior to all other liens and encumbrances"). As a matter of Illinois law, there is no mechanism to prime a lien just because the borrower is in bankruptcy.

25. The cases relied upon by the Debtor are inapposite. In general, those cases relate to ascertaining *priority* of existing liens, and not the creation of priming liens. Debtors have not cited a single case where a bankruptcy court authorized the priming of a first mortgage insured under the National Housing Act. The HUD Lenders have not, and would not, assert that *no* federal lien may be primed; however, because the National Housing Act specifically requires that the

FHA-insured mortgage must be first, it was obviously Congress's intent that these liens be treated differently than other federal liens without a similar statutory mandate.

26. For example, in *United States v. Kimbell Foods*, the United States addressed whether federal or state law governs the priority of liens in the absence of a federal statute setting priorities. 440 U.S. 715 (1979). There, the Supreme Court articulated the general rule that state law priority rules govern *absent a congressional directive*. *Id.* at 740. Importantly, in *Kimbell Foods*, the Supreme Court was ascertaining who had the priority position and not, as the Debtors seek to do here, reordering the priorities already in place. Accordingly, *Kimbell Foods* instructs that courts must look to state law—and in this case Illinois—to ascertain priority status. But here, there is no statute in Illinois that would allow the Debtors to circumvent the first priority mortgage afforded under Illinois law.

27. The Debtors' other cases fare no better. For example, in *Chicago Title*, the bank and Chicago Title filed a declaratory judgment action seeking a declaration that the government's mortgage lien was entitled to priority over a mechanic's lien. *Chicago Title Ins. Co. v. Sherred Village Associates*, 708 F.2d 804, 806-07 (1st Cir. 1983). The Court reasoned that Congress had not "explicitly mandated a federal rule of priority in cases in which a contractor seeks to enforce a mechanics' lien." *Id.* at 809. Accordingly, because the state law provided the mechanic's lien with superpriority status, it held priority over the government lien. But here, the HUD Lenders are holders of the first priority mortgages, not only because the loans stated HUD's first lien status, but because the loans retain first priority under Illinois law. Again, the *Chicago Title* case is inapplicable because there is nothing under Illinois law that suggests that a bankruptcy order can supersede this priority. The HUD Lenders concede that a state statute governing interests in property, like the one at issue in *Chicago Title*, could give a lien like a mechanic's lien priority

over the HUD loans at issue here, much like the court concluded in *Freedom Mortg. Corp. v. Las Vegas Dev. Grp., LLC*, 106 F. Supp. 3d 1174, 1186 (D. Nev. 2016) when applying a state statute that gave homeowner association assessments superpriority. But again, no statute allows for the actions which the Debtors asks this Court to impose.

28. Simply put, the Debtors have not cited a single case wherein a bankruptcy court has subordinated the lien of a first mortgagor under the National Housing Act by a court order priming such mortgage. Instead, the Debtors rely on a series of inapplicable bankruptcy decisions where a HUD-insured loan was involved. For example, *In re Water Gap Village* involved a challenge to the Chapter 11 Plan made by HUD. The court described the issue as whether HUD's regulatory authority, which HUD proposed to use "by approving or disapproving management under the Plan," could be affected by the "cram down" provision of the Bankruptcy Code. 59 B.R. 23, 25 (Bankr. D.N.J. 1985). In finding that HUD was susceptible to the cram down provision, the Court analyzed HUD's role in regulating housing loans. The court reasoned that HUD's role was distinct from, for example, a case involving the Federal Aviation Act (the "FAA"), where the FAA's role in regulating the safety of aircraft and use of airspace was so significant that the Court could not subject the FAA to the jurisdiction of the Bankruptcy Code. *Id.* at 26. Here, the HUD Lenders are not arguing they (or HUD) have the ability to approve or disapprove of a plan, but rather that this Court cannot disrupt its status as holder of a first-priority lien. Accordingly, *In re Way Apts.*, 201 B.R. 444 (N.D. Tex. 1996) is inapposite for the same reason.

29. Moreover, the Debtors' reliance on cases like *Freedom Mortg. Corp. v. Las Vegas Dev. Grp., LLC*, 106 F. Supp. 3d 1174 (D. Nev. 2016) does not move the needle. Those cases specifically rely on a Nevada statute that gives an HOA lien superpriority over all other liens. But here, as discussed above, there is no Illinois statute that provides that a bankruptcy order can

take priority over the existing first mortgage HUD lien. There is nothing before this Court to suggest otherwise.

30. As this Court is well aware, it must read the Bankruptcy Code and the National Housing Act harmoniously. *See In re Welker*, 163 B.R. 488, 489 (Bankr. N.D. Tex. 1994). Because the National Housing Act requires HUD to retain the first mortgage and the Bankruptcy Code is otherwise silent regarding this issue, the Court should maintain the HUD Lender's priority status.

31. The Debtors' reply leads to but one conclusion: removing the HUD loans' status as first lien would be a drastic measure, and there is no case law to support such an action.

B. Disrupting the National Housing Act's First Mortgage Requirement Would Frustrate the National Housing Act's Objectives.

32. The National Housing Act's purpose behind mortgage insurance for nursing homes, assisted living facilities, and board and care facilities and related entities is to facilitate the development of facilities these types. 12 U.S.C. § 1715w(a). In so doing, these loans provide low interest rates to the borrowers to help encourage the development of these entities. In exchange for, among other things, the low interest rate, the HUD-insured loan retains the first mortgage status to minimize the risk of loss to HUD. This is precisely what is occurring here, and precisely why this Court should not subordinate the liens of the HUD-insured mortgagors by priming their liens to the DIP Lender. Instead of ensuring that the HUD loans retain their first mortgage status, the Debtors seek to prime the HUD-insured mortgages in direct contravention of the National Housing Act's requirements.

33. *In re Andover Senior Care, LLC*, cited by the Debtors, is distinguishable. No. 22-10139, 2023 Bankr. LEXIS 1968 (Bankr. D. Kan. Aug. 3, 2023). Importantly, the court reviewed whether it had discretion to modify certain language in the loan agreements between

HUD and the debtor. Notably, in *Andover*, the HUD lender retained its first mortgage lien—it was not subject to priming by the Bankruptcy Court. *Id.* at *17. That the HUD loan was subject to the cram down of the debtor's plan does not support the Debtors' effort to extinguish the HUD Lender's first priority status, which did not occur in *Andover*.[6]

34. Further, balancing the goals of the National Housing Act with the Bankruptcy Code establishes that this Court should not disrupt the HUD Lender's first mortgage position. In *In re Capital W. Investors*, the district court considered whether the bankruptcy court properly balanced the goals of the National Housing Act and Chapter 11 of the Bankruptcy Act when the bankruptcy court deleted portions of the HUD Regulatory Agreement governing the note. 186 B.R. 497, 499 (N.D. Cal. 1995). The district court reversed. *Id.* at 500. The Court reasoned that the "positive effect" of forestalling foreclosure "pales in comparison to the possible negative ramifications that will result from the precedential effect of allowing a debtor to avoid provisions of a HUD Regulatory Agreement simply by filing for bankruptcy." *Id.* The court summed up the issue by noting 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." *Id.* This is precisely why the Court here should not grant the DIP Motion: the precedent that would be established will have lasting and significant effects on HUD-insured lending, in direct contravention of the purposes of the National Housing Act, and will saddle the federal government with unintended costs due to its loss of the priority of its lien whenever a HUD project owner files bankruptcy. Additionally, any notion that by contravening HUD's first mortgage requirement will somehow

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[6] The HUD Lenders do not concede that a court can subject HUD loans to cramdown but acknowledge the holding in *Andover* states otherwise. Nevertheless, cramdown is not at issue in this proceeding.

prevent harm to the facilities ignores important safeguards to the contrary. As a threshold matter, the State of Illinois maintains oversight of assisted living and nursing home facilities through extensive licensing and inspection procedures. For example, if the Illinois Department of Public Health, which controls the licensure of a nursing home, determines that the nursing home facility is closing without enough time to transfer the residents or it determines that an emergency exists that would be a threat to the health, safety, or welfare of the residents, the Department can place an agent to monitor the facility and assist with the closure and/or transfer of residents. 77 Ill. Adm. Code § 300.270. When a nursing home files for bankruptcy, the court can appoint an ombudsman to monitor the quality of patient care and represent the interests of the patients. 11 U.S.C. § 333. Accordingly, the Bankruptcy Code and Illinois regulations specifically acknowledge the potential for a nursing facility to file for bankruptcy while maintaining safe living conditions for the residents.

35. Moreover, disrupting the first lien position for the HUD Lenders could change the way nursing home facilities obtain financing for operations. As of December 31, 2023, there were 3,668 facilities in the HUD Section 232 program. Disregarding the statutory requirements of the National Housing Act here could result in a serious adverse impact on the HUD Section 232 program should lenders and HUD find their first mortgages on which the program is based can suffer the loss the priority of their insured mortgages. That, in turn, would have a negative effect on the provision of medical and nursing care to hundreds of thousands of residents, who depend on HUD-insured facilities (like those at issue here) for care.

C. Debtors Cannot Satisfy the Requirements of Bankruptcy Code Sections 364(d)(1)(B) and 364(d)(2)

36. The Bankruptcy Code and the case law interpreting it make clear that, when post-petition financing seeks to prime a pre-existing secured lender, the debtor must show that the

lien to be primed is adequately protected. *See* 11 U.S.C. § 364(d)(2); *In re Swedeland Dev. Group, Inc*., 16 F.3d 552, 564 (3d Cir. 1994) ("A debtor has the burden to establish that the holder of the lien to be subordinated has adequate protection."); *In re Grant Broad. of Phila., Inc*., 71 B.R. 376, 385 (Bankr. E.D. Pa.), *aff'd*, 75 B.R. 819 (E.D. Pa. 1987) (finding that the Debtors have the burden of showing adequate protection). In the context of a priming DIP loan, adequate protection serves to protect a prepetition lender from increased risk as a result of the post-petition financing. 3 Collier on Bankruptcy ¶ 364.05 (16th ed. 2023) ("When the effect of the new borrowing from a senior lender is merely to pass the risk of loss to the holder of the prepetition lien, the request for authorization should be denied absent the lien holder's consent. The authorization to prime an existing lien should not be read as authorization to increase substantially the risk of the prepetition lender in order to provide additional protection for a new, postpetition lender."). "Given the fact that super priority financing *displaces liens* on which creditors have relied in extending credit, a court that is asked to authorize such financing must be particularly cautious when assessing whether the creditors so displaced are adequately protected." *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716, 754 (S.D. Fla. 2010) (emphasis in original; internal quotation marks and citation omitted).

37. For this reason, Section 361 of the Bankruptcy Code sets forth a non-exhaustive list of appropriate forms of adequate protection, including "periodic cash payments" and "an additional or replacement lien," and recognizes that other forms of adequate protection may be appropriate in order to "result in the realization by such entity of the indubitable equivalent of such entity's interest in such property." *See* 11 U.S.C. § 361. In the context of priming, adequate protection conceivably may be found where there is "sufficient equity in the subject property to protect the existing lienholder," or a so-called "equity cushion." 3 Collier on Bankruptcy ¶ 364.05

(16th ed. 2023). It is this supposed "equity cushion," posited by the Debtors to exist when one takes all of the Debtors' facilities into account, upon which Debtors rely.

38. However, the Debtors have provided questionable evidence that such an equity cushion exists across all of the Debtors' facilities, and no evidence whatsoever of an equity cushion with regard to individual facilities that exceeds the priming liens and superpriority claims that are to become senior to the HUD Lenders. Under the Debtors' Proposed Final Order, the replacement liens proposed for the HUD Lenders are both deeply subordinated and limited to the discrete pool of collateral on which each HUD Lender already has a prepetition lien, so it is immaterial what equity might exist in assets on which that HUD Lender has no prepetition lien.

39. Even assuming that replacement liens are proposed across all facilities, such that diminution suffered by a secured lender to one Debtor would receive a replacement lien on the assets of all other Debtors, the proposed DIP Liens and Permitted Prior Liens (which are both to be made senior to the HUD Lenders' prepetition liens) impose significant risk on the HUD Lenders. Notwithstanding the Debtors' revisions to the proposed Final Order – setting out that the priming liens shall not apply to a subset of the HUD Lenders' collateral, the value of the HUD Lenders' interest in the remainder of their collateral is not only inadequately protected, but in fact is to be entirely eroded.

40. "Congress did not contemplate that a secured creditor could find its position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependent upon the success of a business with inherently risky prospects." *In re Swedeland Dev. Group, Inc.*, 16 F.3d at 567. While the Debtors appear to no longer propose that priming liens apply to the "grounds, buildings, and fixtures and any improvements thereon . . . and any funds in escrow or reserves relating to such real property" of the HUD Lenders' real estate, *see* Proposed Final Order

⁋11(c), the remainder of the HUD Lenders' collateral, including the "accounts receivable, the going concern value of the assets of the HUD Debtors (including, without limitation, licenses, permits, and goodwill) or any other assets of the HUD Debtor other than the ground, buildings, and fixtures and improvements thereon" is to be subjected to a multitude of priming liens. *Id*. Granting the DIP Lender a priming lien for $45 million (plus interest and $8 million in exit fees) results in the diminution of the HUD Lenders' interest in the amount of more than $48 million, which essentially leaves the HUD Lenders with nothing. In this way, the proposed Final DIP Order affords even less adequate protection than previously proposed protection in the DIP Motion because the replacement liens described in paragraph 13(c) of the Proposed Final Order – for each objecting HUD Lender, a lien on just its own prepetition collateral, as opposed to a lien on all of the Debtors' assets – secure the HUD Lenders' diminution claims with a far less collateral value than they had pre-petition. *C.f. In re Swedeland* 16 F.3d at 564 ("The whole purpose of adequate protection for a creditor is to insure that the creditor receives the value for which he bargained prebankruptcy."); *In re Satcon Tech. Corp.*, No. 12-12869 KG, 2012 WL 6091160, at *6 (Bankr. D. Del. Dec. 7, 2012) ("The focus of [the adequate protection] requirement is to protect a secured creditor from diminution in the value of its interest in the *particular collateral* during the period of use by the debtor.") (emphasis added).

41. Here, the proposed adequate protection originally was based upon the real estate value estimates provided by the Debtors' CRO, who, by his own admission, is neither an appraiser nor a broker, and does not give broker record valuations. First Day Hearing Tr. 83:6-11. Even that speculative "valuation" was for the entirety of the Debtors' facilities, and provided no insight in the equity cushion that might exist for any particular Debtor. Just last week, the Debtors filed a Declaration of Mark Myers that purports to value each of the Debtors' facilities at an amount

that exceeds the pre-petition balance of the associated loan. On no individual facility does that purported equity cushion even approach the amount of debt that the Debtors propose to layer onto the facility ahead of the liens and claims of the relevant Prepetition Secured Party.

42. Moreover, weeks into these cases, the Debtors have only just now filed a motion seeking approval of bidding procedures and to engage in a Court-approved post-petition marketing and sale process. The Debtors do not offer interest payments, current payment of attorneys' fees, any additional unencumbered collateral, or any other value of any kind to offset the massive diminution to the HUD Lenders' interests that the Debtors propose. Therefore, under *Swedeland*, the Pre-Petition Lenders are not adequately protected.

43. Having failed to meet their burden to establish that the HUD Lenders' interest in their collateral will be adequately protected, as required by Bankruptcy Code Sections 364(d)(1)(B) and 364(d)(2), the Debtors' DIP Motion should be denied.

D. Debtors Should not be Permitted to Waive Marshaling

44. As noted above, the DIP Motion also requests that the Final Order contain "no marshaling" provisions. *See* DIP Motion, p. 18. "Marshaling is an equitable doctrine which provides that where a creditor has two funds from which to satisfy its debt, it 'may not, by application of them to [its] demand, defeat another creditor who may resort to only one of the funds." *In re High Strength Steel, Inc*., 269 B.R. 560, 572 (Bankr. D. Del. 2001). The purpose of marshaling is "to prevent the arbitrary action of a senior lienor from destroying the rights of a junior lienor or a creditor having less security." *Meyer v. U.S*., 375 U.S. 233, 237 (1963). Marshaling applies "where a creditor, by virtue of a lien or interest, can resort to two funds for payment, while another can only resort to one of the funds." *In re Ector County Energy Center, LLC*, Case No. 22-10320 (JTD) (Bankr. D. Del.), Jun. 2, 2022 Hr'g Tr., 7:24-8:1. For this reason,

waivers of the equitable doctrine of marshaling are not granted as a matter of course (absent consent), but rather are permitted only where there is a showing of its propriety.

45. Such a waiver is not appropriate here, absent an allocation mechanism acceptable to the HUD Lenders. The DIP Loan is secured by assets of all the Debtors, but no individual Debtor will realize the benefit of the entirety of the DIP Loan. It is not presently known in what order the Debtors' facilities will sell, or even whether every facility will be sold. It also is not presently known whether any given Debtor's case ultimately will be dismissed, or its facility abandoned. The HUD Lenders do not dispute that the DIP Lender should receive the benefit of its bargain and be assured of payment. However, where the collateral package spans numerous Debtors, each with its own set of secured prepetition loans and secured lender, it is imperative that the Court retain full authority to ensure that collateral and the proceeds thereof are applied to reduce DIP Loan obligations in a manner that does not does not benefit one Prepetition Secured Party at the expense of another. At this stage of these cases, there is no basis in law or equity to order a waiver of marshaling.

E. Other Issues

46. In addition to the objections stated above, the HUD Lenders object to the following provisions of the Proposed Final Order and submit that each must be revised as described below.

a. Paragraph Q of the Proposed Final Order provides that Approved Budgets "the U.S. Trustee, counsel for the Prepetition Secured Parties, counsel for U.S. Department of Housing and Urban Development ("HUD"), and counsel to the Committee in summary form." Given that the HUD Lenders' cash collateral is being used,

and their collateral is being primed to some degree to facilitate continued operations, they have no less an interest in the Approved Budgets than the DIP Lender. All Prepetition Secured Parties should be provided with the same level of detail regarding Budgets as is provided to the DIP Lender.

RESERVATION OF RIGHTS

47. The HUD Lenders reserve the right to supplement this Objection, to assert any other and further objections to the DIP Motion, to join in any objections of other parties, and to seek or assert any other rights or remedies available to them in these bankruptcy cases, including but not limited to the right to seek additional or different adequate protection, to seek relief from the automatic stay and/or to seek conversion or dismissal of any of the Debtors' Chapter 11 Cases.

CONCLUSION

48. For the reasons set forth above the HUD Lenders respectfully request that the Court deny final approval of the relief sought in the DIP Motion.

Dated: May 10, 2024
Wilmington, Delaware

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, David M. Fournier, hereby certify that on the 10th day of May, 2024, I caused the foregoing *Joint Objection of HUD Lenders to 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* to be served by email upon the parties set forth on the attached list; and all ECF participants registered in this case were served electronically on the date of filing through the court's ECF system at their respective email addresses registered with the court.

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