United States Bankruptcy Court
Central District of California
Los Angeles
Judge Ernest Robles, Presiding
Courtroom 1568 Calendar

Wednesday, September 5, 2018 **Hearing Room 1568**

10:00 AM
2:18-20151 Verity Health System of California, Inc. **Chapter 11**

#25.00 Hearing
RE: [29] Debtors Emergency Motion For Entry Of An Order Authorizing Debtors To Honor Prepetition Obligations To Critical Vendors

Docket 29

Matter Notes:

9/5/2018

The tentative ruling will be the order.
Party to lodge order: Movant

POST PDF OF TENTATIVE RULING TO CIAO

Order to incorporate comments from objecting party.

Tentative Ruling:

9/4/2018

Subject to any opposition which may be presented at the hearing, the Court is prepared to authorize the Debtors to pay Critical Vendors $5 million on an interim basis. A Final Hearing shall be held on **October 3, 2018, at 10:00 a.m.**

Pleadings Filed and Reviewed:

1) Debtors' Emergency Motion for Entry of an Order Authorizing Debtors to Honor Prepetition Obligations to Critical Vendors [Doc. No. 29] (the "Motion")
   a) Declaration of Richard G. Adcock in Support of Emergency First-Day Motions [Doc. No. 8]
   b) Declaration of Anita Chou, Chief Financial Officer, in Support of Motion for Interim Order Authorizing (A) Use of Cash Collateral; (B) Debtor in Possession Credit Agreement; (C) Grant of Superpriority Priming Liens to DIP Lender; and (D) Grant of Junior Liens on Post-Petition Accounts and Inventory as Adequate Protection to Prepetition S

U.S.C. §§105(A), 363(C)(2), and 364(C) and (D)
c) Order Setting Hearing on First Day Motions [Doc. No. 18]
d) Amended Notice of Hearings on Emergency First-Day Motions Filed by Debtors [Doc. No. 34]

2) Combined Reservation of Rights of U.S. Bank National Association, as Series 2015 Note Trustee and Series 2017 Note Trustee, to Debtors' Emergency Motion for Entry of an Order Authorizing Debtors to Honor Prepetition Obligations to Critical Vendors [Doc. No. 69]

I. Facts and Summary of Pleadings

Background information on the Debtors is set forth in the tentative ruling on the Debtors' emergency motion for authorization to obtain secured credit and to authorize the use of cash collateral, and is not repeated here.

A. The Motion

The Debtors move for entry of an interim order authorizing, but not directing, the Debtors to continue to pay and/or honor prepetition claims, in an interim amount of up to $5 million. The Debtors make the following arguments and representations in support of the Motion:

The Debtors operate a nonprofit safety-net healthcare system that provides medical care for over 300,000 patients per year. To continue operations, the Debtors must be authorized to make prepetition payments to certain medical suppliers, medical care providers, and critical service providers (collectively, the "Critical Vendors").

The Debtors and their advisors have developed a protocol to identify only those vendors most critical to the Debtors' continued operations (the "Protocol"). Under the Protocol, a vendor is a Critical Vendor if that vendor meets the following criteria:

1) The vendor is essential to patient care, supports maintaining the Debtors' business in full compliance with all applicable legal requirements, and allows the Debtors to continue to provide essential and life-saving patient care and services;
2) The vendor is indispensable for providing vital goods and services (such as blood products or surgical implants), could not be replaced without prohibitive expense, or is critical to prevent the diversion of management and key personnel;
3) The vendor will most likely refuse to deliver vital goods or services without

payment of its prepetition claim, and the automatic stay is inadequate to address the issue;

4) Cash on delivery is unlikely to provide the requisite incentive for the vendor to continue providing goods or services;
5) The Debtors lack a long-term contractual relationship with the vendor that would oblige the vendor to continue the prepetition relationship;
6) The Debtors are otherwise without adequate leverage to compel performance on commercially reasonable terms;
7) The Debtors will suffer immediate and irreparable harm if the vendor is not specially incentivized to continue providing essentially goods or services.

The Debtors will use commercially reasonable efforts to require the vendor to sign a postpetition agreement with normalized terms and conditions that contractually binds the vendor to continue providing essential goods and services postpetition (the "Critical Vendor Agreement").

Critical Vendors fall into the following categories:

1) **Uncompensated Care and On-Call Coverage Physicians**. The Debtors require the services of various physicians who provide care to patients who lack the ability to pay the Debtors for their medical treatment. Uncompensated Care Contract Physicians provide life-saving medical care and treatment for patients who cannot pay for such care. On-Call Coverage Physicians ensure that specialty physician services are available at all times for all patients, regardless of the patient's ability to pay. Due to a strong economy and tight labor market, Uncompensated Care Contract Physicians and On-Call Coverage Physicians would likely leave to work at other hospitals if they did not receive payment on account of their prepetition claims.
2) **Medical Directors**. Medical Directors ensure that the Debtors' Hospitals provide patient care efficiently and in compliance with state and federal laws, rules, and regulations. Absent payment on account of their prepetition claims, Medical Directors would likely leave to work at other hospitals.
3) **Medical Leadership**. In order to maintain the accreditations that are necessary to enable the Hospitals to retain their certifications under the Medicare and Medi-Cal programs, the Debtors require the services of various physicians who serve as medical staff officers or who occupy

United States Bankruptcy Court
Central District of California
Los Angeles
Judge Ernest Robles, Presiding
Courtroom 1568 Calendar

Wednesday, September 5, 2018 **Hearing Room 1568**

10:00 AM
CONT... **Verity Health System of California, Inc.** **Chapter 11**

various other leadership positions. Absent payment on account of their prepetition claims, these physicians would likely leave to work at other hospitals.

4) **Physician Educators**. The Debtors require the services of various physicians who provide teaching services in the Debtors' graduate medical education ("GME") program. The GME program trains physicians who provided needed staffing for the Debtors' hospitals. Physician Educators are in high demand because they are highly skilled—they must not only be experts in their fields, but they must also meet stringent qualifications under the government's GME requirements. Without the Physician Educators, the Debtors would lose their GME program. The GME Program is a require program for the Level II Trauma Center at St. Vincent Medical Center. Physician Educators would likely leave to work at other hospitals absent payment on their prepetition claims.
5) **Medical Services Providers**. The Debtors require the services of various Medical Services Provides, including providers of surgical anesthesia coverage, organ harvesting and organ matching services, medical equipment sanitization, diagnostic interventional cardiology services, imaging services, advanced wound care, laboratory services, dialysis services, and medical screening services, among others.
6) **Medical Supplies and Equipment Providers**. The Debtors require the use of various medical supplies and medical equipment, including without limitation blood and plasma, heart valves, defibrillators, surgical medical products, pharmaceuticals, radiational equipment, cochlear implants, and sterilization equipment.
7) **Clinical Staffing**. The Debtors require various medical staffing agencies to provide numerous personnel essential to operating hospitals, including without limitation nurses, nurse practitioners, physicians assistances, imaging technicians, surgical technicians, and admission department staff. Because Debtors must comply with mandatory California nurse-to-patient ratios, the Debtors are required to increase nurse staffing depending upon daily patient census.
8) **Non-Medical Services Providers**. The Debtors require services of various non-medical service provides, including without limitation providers offering payroll tax services, financial audit services, billing services, cost reporting services, and revenue cycle management services.

United States Bankruptcy Court
Central District of California
Los Angeles
Judge Ernest Robles, Presiding
Courtroom 1568 Calendar

Wednesday, September 5, 2018 **Hearing Room 1568**

10:00 AM
CONT... **Verity Health System of California, Inc.** **Chapter 11**

9) **IT Service Providers**. The Debtors require the use of various information technology services, including without limitation services supporting diagnostic technology, device interoperability, risk management software, revenue cycle management billing software, customer relationship management software, and networking services.
10) **Benefits Providers**. The Debtors have incentivized their employees to continue working through the continuation of company-subsidized benefits, such as workers compensation, medical, dental, and vision benefits, and life insurance benefits. If the Debtors are not permitted by pay any prepetition premium amounts due to these Benefits Providers, the employees' insurance coverage will be jeopardized and the employees will likely seek employment elsewhere.

All Critical Vendors will be required to sign a Critical Vendor Agreement. If, after signing the Critical Vendor Agreement, the Critical Vendor thereafter refuses to supply goods and services to the Debtors throughout the course of the bankruptcy proceeding, the Debtors may (a) deem payments to the defaulting Critical Vendor to be a voidable post-petition transfer pursuant to §549(a) and (b) may demand the immediate return of any and all payment made to the defaulting Critical Vendor.

B. Reservation of Rights by the Notes Trustee

U.S. Bank, in its capacity as the 2015 Note Trustee and the 2017 Note Trustee, responds to the Critical Vendor Motion as follows:

The Notes Trustee acknowledges that the Debtors' business is complex and that payment of certain vendors may be necessary to enhance the value of the bankruptcy estates. However, payment of critical vendors is a form of extraordinary relief that is not specifically authorized by any section of the Bankruptcy Code. If permitted, it will allow the Debtors to use collateral pledged to the repayment of certain prepetition secured creditors, like the Notes Trustee, to make payments to unsecured or other creditors whose claims may otherwise be paid last. Further, the Debtors, at their discretion, can decide which Critical Vendor claims should be paid and in what amounts. Accordingly, it is important to allow all creditors sufficient time to understand how the Debtors' requests may impact creditors' relative priorities and security positions.

Based upon the foregoing, the Notes Trustee the Notes Trustee has a significant

United States Bankruptcy Court
Central District of California
Los Angeles
Judge Ernest Robles, Presiding
Courtroom 1568 Calendar

Wednesday, September 5, 2018 **Hearing Room 1568**

10:00 AM
CONT... Verity Health System of California, Inc. Chapter 11

interest in making sure that interim payments to Critical Vendors are only made where necessary to avoid immediate and irreparable harm to the Debtors. Moreover, the Notes Trustee has an interest in understanding the need for, and the proposed uses of, the additional up to $15 million in potential Critical Vendor payments that may be authorized on a non-interim basis. At this time, the Notes Trustee does not expect to have a full understanding of these issue by the first day hearing on the Motion.

II. Findings and Conclusions

The Court notes that in dicta, the Supreme Court has recently noted that Bankruptcy Courts have approved "'critical vendor' orders that allow payment of an essential suppliers' prepetition invoices." *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 985, 197 L. Ed. 2d 398 (2017). The Supreme Court's statement in *Jevic* obviously was not a holding upon the validity of a critical vendor order; nonetheless, the Supreme Court's acknowledgment that Bankruptcy Courts have reasoned that critical vendor orders are necessary to "enable a successful reorganization and make even the disfavored creditors better off" is significant. *Id.* at 985.

More on point, in the context of a cross-collataralization clause, the Ninth Circuit has recognized that "[c]ases have permitted unequal treatment of pre-petition debts when necessary for rehabilitation, in such contexts as (i) pre-petition wages to key employees; (ii) hospital malpractice premiums incurred prior to filing; (iii) debts to providers of unique and irreplaceable supplies; and (iv) peripheral benefits under labor contracts." *Burchinal v. Central Wash. Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 1490 (9th Cir. 1987). The Ninth Circuit's recognition of the necessity of paying prepetition debts to "providers of unique and irreplaceable supplies" is particularly salient; that relief is most analogous to the relief sought by the instant Motion.

The Debtors have established that there is a strong likelihood that they may suffer irreparable harm if they are not able to pay Critical Vendors. The Debtors have adopted rigorous procedures to limit the amounts to be paid to Critical Vendors on account of prepetition debt.

Such prepetition payments obviously are frowned upon because they subvert the Bankruptcy Code's priority scheme. Yet the priority scheme will be of little use to anyone if value is destroyed because the Debtors cannot continue operations. There is a credible threat that the Debtors will not be able to obtain needed services and supplies absent authorization to pay Critical Vendors.

The Motion is GRANTED on an interim basis. A Final Hearing shall be held on **October 3, 2018, at 10:00 a.m.** Opposition to the Debtor's ability to pay an additional

United States Bankruptcy Court
Central District of California
Los Angeles
Judge Ernest Robles, Presiding
Courtroom 1568 Calendar

Wednesday, September 5, 2018 **Hearing Room 1568**

10:00 AM
CONT... Verity Health System of California, Inc. **Chapter 11**

$15 million to Critical Vendors is due by no later than **September 19, 2018**. The Debtor's reply in support of continued authorization is due by **September 26, 2018**.

Party Information

Debtor(s):

Verity Health System of California,	Represented By Samuel R Maizel John A Moe Tania M Moyron