Docket #3880 Date Filed: 12/30/2019

GREGORY A. BRAY (Bar No. 115367)
gbray@milbank.com
MARK SHINDERMAN (Bar No. 136644)
mshinderman@milbank.com
JAMES C. BEHRENS (Bar No. 280365)
jbehrens@milbank.com
MILBANK LLP
2029 Century Park East, 33rd Floor
Los Angeles, CA 90067
Telephone: (424) 386-4000/Facsimile: (213) 629-5063

Counsel for the Official Committee of Unsecured Creditors of Verity Health System of California, Inc., et al.

UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA – LOS ANGELES DIVISION

In re:

VERITY HEALTH SYSTEM OF CALIFORNIA, INC., *et al.*,

Debtors and Debtors In Possession.

Affects:

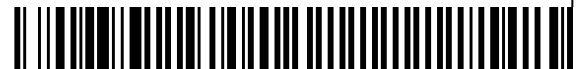
☑ All Debtors
☐ Verity Health System of California, Inc.
☐ O'Connor Hospital
☐ Saint Louise Regional Hospital
☐ St. Francis Medical Center
☐ St. Vincent Medical Center
☐ Seton Medical Center
☐ O'Connor Hospital Foundation
☐ Saint Louise Regional Hospital Foundation
☐ St. Francis Medical Center of Lynwood Foundation
☐ St. Vincent Foundation
☐ St. Vincent Dialysis Center, Inc.
☐ Seton Medical Center Foundation
☐ Verity Business Services
☐ Verity Medical Foundation
☐ Verity Holdings, LLC
☐ De Paul Ventures, LLC
☐ De Paul Ventures - San Jose Dialysis, LLC

Debtors and Debtors In Possession.

Lead Case No. 2:18-bk-20151-ER
Jointly Administered With:
CASE NO.: 2:18-bk-20162-ER
CASE NO.: 2:18-bk-20163-ER
CASE NO.: 2:18-bk-20164-ER
CASE NO.: 2:18-bk-20165-ER
CASE NO.: 2:18-bk-20167-ER
CASE NO.: 2:18-bk-20168-ER
CASE NO.: 2:18-bk-20169-ER
CASE NO.: 2:18-bk-20171-ER
CASE NO.: 2:18-bk-20172-ER
CASE NO.: 2:18-bk-20173-ER
CASE NO.: 2:18-bk-20175-ER
CASE NO.: 2:18-bk-20176-ER
CASE NO.: 2:18-bk-20178-ER
CASE NO.: 2:18-bk-20179-ER
CASE NO.: 2:18-bk-20180-ER
CASE NO.: 2:18-bk-20181-ER
Chapter 11 Cases

Hon. Ernest M. Robles

OFFICIAL COMMITTEE OF UNSECURED CREDITORS' OPPOSITION TO ENTRY OF FIRST AMENDED SUPPLEMENTAL CASH COLLATERAL ORDER AND STIPULATION TO (A) AMEND CASH COLLATERAL AGREEMENT AND SUPPLEMENTAL CASH COLLATERAL ORDER, (B) AUTHORIZE CONTINUED USE OF CASH COLLATERAL, (C) GRANT ADEQUATE PROTECTION, (D) MODIFY AUTOMATIC STAY, AND (E) GRANT RELATED RELIEF [DOCKET NO. 3871]



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The Official Committee of Unsecured Creditors of Verity Health System of California, Inc., *et al*. (the "Committee"), appointed in connection with the chapter 11 cases (the "Chapter 11 Cases") of the above-captioned debtors and debtors-in-possession (the "Debtors"), hereby opposes (the "Opposition") (i) approval of the *Stipulation to (A) Amend Cash Collateral Agreement and Supplemental Cash Collateral Order, (b) Authorize Continued Use of Cash Collateral, (C) Grant Adequate Protection, (D) Modify Automatic Stay, and (E) Grant Related Relief* [Docket No. 3871] (the "CCO Stipulation"); and (ii) entry of the First Amended Supplemental Cash Collateral Order in the form annexed to the CCO Stipulation as Exhibit "A" (the "First Amended Supplemental Cash Collateral Order").[1] In support of its Opposition, the Committee respectfully states as follows:

PRELIMINARY STATEMENT

The Committee objects to the approval of the proposed CCO Stipulation and entry of the First Amended Supplemental Cash Collateral Order for three overarching reasons. *First*, the Committee objects to the entry of First Amended Supplemental Cash Collateral Order and approval of the CCO Stipulation to the extent that they continue to permit the Debtors to use the proceeds of such unencumbered assets for the benefit of the Prepetition Secured Creditors *while waiving the estates' rights under sections 506 and 552 of Bankruptcy Code and marshaling principles on a going-forward basis.* Such a blanket waiver is inappropriate given what is currently known about the status of Debtors' assets and the Prepetition Secured Creditors' liens and claims as to such assets. It is undisputed, as set forth below, that the Prepetition Secured Creditors do not have perfected security interests in certain of those assets; dispute remains as to certain other assets, but, regardless, the implication is that some quantum of unencumbered assets is being consumed for the benefit of secured creditors, such that the Debtors need to preserve the right to seek section 506(c) surcharge and section 552(b) allocation for the benefit of their unsecured creditors.

[1] Capitalized terms not otherwise defined herein shall have the meanings ascribed to them in the CCO Stipulation, the First Amended Supplemental Cash Collateral Order, the Committee DIP Objection, or the Committee Cash Collateral Response.

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Second, over the course of these cases, the Committee has also come to believe that the Prepetition Secured Creditors may not be oversecured. Accordingly, to the extent that the Prepetition Secured Creditors are ultimately shown to ***not*** have been oversecured, any postpetition payments made to them, for adequate protection purposes or otherwise, should instead be applied to reduce the principal balance of their claims.

Finally, as the Committee understands the Cash Collateral Budget, in the form annexed to the CCO Stipulation as Exhibit "A" to the *Supplement to Stipulation to (A) Amend Cash Collateral Agreement and Supplemental Cash Collateral Order, (b) Authorize Continued Use of Cash Collateral, (C) Grant Adequate Protection, (D) Modify Automatic Stay, and (E) Grant Related Relief* [Docket No. 3872] (the "Cash Collateral Budget"), the Budget does not provide for the payment in full of certain administrative expense claims that may have.

BACKGROUND

On August 31, 2018 (the "Petition Date"), each of the above-captioned Debtors filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code with the United States Bankruptcy Court for the Central District of California (the "Court"). The Debtors have continued in the management and operation of their businesses and properties as debtors in possession pursuant to §§ 1107 and 1108. On September 17, 2018, the Committee was appointed in these Chapter 11 cases.

On the Petition Date, the Debtors filed their *Emergency Motion of Debtors for Interim and Final Orders (A) Authorizing the Debtors to Obtain Post Petition Financing (B) Authorizing the Debtors to Use Cash Collateral and (C) Granting Adequate Protection to Prepetition Secured Creditors Pursuant to 11 U.S.C. §§ 105, 363, 364, 1107 and 1108* [Docket No. 31] (the "DIP Financing Motion"). On September 27, 2018, the Committee filed a limited objection [Docket No. 316] to the DIP Financing Motion (the "Committee DIP Objection"). On October 4, 2018, the

1 Court entered an order [Docket No. 409] (the "Final DIP Order") granting the DIP Financing Motion
2 on a final basis. The Final DIP Order is currently on appeal before the Ninth Circuit [Case No. 19-
3 55997].
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5 Pursuant to challenge rights granted to the Committee in the Final DIP Order, the Committee
6 conducted a collateral review and lien investigation that resulted in the Committee's filing of two
7 adversary proceedings [Adversary Proceeding Nos. 2:19-ap-01165-ER and 2:19-ap-01166-ER] (the
8 "Adversary Proceedings") and a claim objection [Docket No. 3634] (the "Claim Objection") against
9 certain Prepetition Secured Creditors. The Adversary Proceedings and Claim Objection challenge,
10 among other things, the Prepetition Secured Creditors' liens and claims with respect to certain
11 deposit and other accounts, QAF receivables, and office building and "going concern" sale proceeds.
12
13 On August 28, 2019, the Debtors filed their *Debtors' Notice of Motion and Motion for Entry*
14 *of an Order (A) Authorizing the Debtors to Use Cash Collateral and (B) Granting Adequate*
15 *Protection to Prepetition Secured Creditors* [Docket No. 2962] (as modified by Docket No. 2968,
16 the "Cash Collateral Motion"). On September 4, 2019, the Committee filed a response [Docket No.
17 3000] (the "Committee Cash Collateral Response"). On September 6, 2019, the Court entered its
18 *Final Order (A) Authorizing Continued Use of Cash Collateral, (B) Granting Adequate Protection,*
19 *(C) Modifying Automatic Stay, and (D) Granting Related Relief* [Docket No. 3022], granting the
20 Cash Collateral Motion (the "Supplemental Cash Collateral Order").
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22 In the CCO Stipulation and the First Amended Supplemental Cash Collateral Order, the
23 Debtors state that they have an immediate and continuing need to use cash collateral in order to
24 continue their operations and to administer and preserve the value of their estates until the
25 anticipated sale and transfer of the remainder of their facilities to one or more acquirers, and to
26 distribute the assets of the Debtors' estates to their creditors. The Debtors contend that they
27 requested that the Prepetition Secured Creditors consent to their continuing use of cash collateral
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under the Final DIP Order and additional use of the Escrowed Cash Collateral, the use of which is restricted by the Final DIP Order and the Supplemental Cash Collateral Order. The Prepetition Secured Creditors, according to the Debtors, have advised that they are willing to consent to continuing use of cash collateral conditioned upon (i) the furnishing of additional adequate protection (the "Supplemental Adequate Protection"); (ii) the terms of the First Amended Supplemental Cash Collateral Order; and (iii) compliance with certain Disposition Milestones attached to the CCO Stipulation and filed under seal.

ARGUMENT

A. The Debtors' Estates Had, and Continue To Have, Significant Unencumbered Assets

The Debtors' estates had on the Petition Date, and continue to have, significant unencumbered assets. The Committee believes that it is undisputed that the Prepetition Secured Creditors did not have a perfected security interest in certain deposit accounts existing on the Petition Date, the proceeds of which were used to fund operations. It is also undisputed that the Prepetition Secured Creditors did not have a perfected lien in certain other deposit accounts (due to the lack of deposit account control agreements) as of the Petition Date, although those accounts may have contained identifiable cash proceeds. Together, these accounts contained more than $70 million as of the Petition Date, funds that have largely been consumed by continuing operations. So, too, is it undisputed that Prepetition Secured Creditors, other than the MOB Lenders, did not have a lien in the expected excess value of the medical office buildings (the value of the medical office buildings in excess of the MOB Lenders' liens) or in various other properties for which the Debtors' own appraisals show significant surplus value.

The Committee also contends in the pending Adversary Proceedings and Claim Objection that the Prepetition Secured Creditors' liens do not attach to certain postpetition QAF payments and

that a portion of the "going concern premium" generated by the sale of assets as a going concern must be allocated to unsecured creditors based on applicable facts and law.

B. Absent Protections Afforded by Sections 506 and 552 of Bankruptcy Code and Marshaling Principles, CCO Stipulation Would Permit Prepetition Secured Creditors to Benefit from Debtors' Use of Unencumbered Assets at Unsecured Creditors' Expense

Notwithstanding the above-referenced deficiencies or "holes" in the Prepetition Secured Creditors' collateral, the CCO Stipulation and the First Amended Supplemental Cash Collateral Order would permit the estates to use the proceeds of such unencumbered assets to facilitate the sale of their remaining assets, the proceeds of which would be paid first and foremost to the Prepetition Secured Creditors (until such time the Prepetition Secured Creditors are paid in full), to the detriment of the Debtors' unsecured creditors.

To obviate such detriment, the Debtors' estates must be permitted to preserve *the rights to seek to surcharge* with regard to the Prepetition Secured Creditors' collateral and *allocate value generated postpetition* under sections 506 and 552 of the Bankruptcy Code and otherwise applicable law (including marshaling principles, as may be appropriate). Otherwise, once again, the Debtors' estates and their unsecured creditors would effectively be compelled to finance the Prepetition Secured Creditors' efforts to maximize the value of their collateral. Section 506(c) was intended by Congress to ensure that secured creditors pay the costs associated with maintaining or disposing of their collateral during bankruptcy cases. *See, e.g., Precision Steel Shearing v. Fremont Fin. Corp. (In re Visual Indus., Inc.)*, 57 F.3d 321, 325 (3d Cir. 1995) (section 506(c) "is . . . designed to prevent a windfall to the secured creditor . . . . The rule understandably shifts to the secured party . . . the costs of preserving or disposing of the secured party's collateral, which costs might otherwise be paid from the unencumbered assets of the bankruptcy estate."); *In re Codesco, Inc.*, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) ("The underlying rationale for charging a lienholder with the costs and expenses of preserving or disposing of the secured collateral is that the general estate and unsecured

1 creditors should not be required to bear the cost of protecting what is not theirs."); *In re Proto-*
2 *Specialties, Inc.*, 43 B.R. 81, 83 (Bankr. D. Ariz. 1984) (same).
3
4 Courts have rejected attempted waivers of surcharge rights under section 506(c) where the
5 recoveries of a debtor's unsecured creditors have been shown to be at greater risk than those of its
6 secured creditors. *See, e.g.*, *Hartford Fire Ins. Co. v. Norwest Bank Minn., N.A. (In re Lockwood*
7 *Corp.)*, 223 B.R. 170, 176 (B.A.P. 8th Cir. 1998) (holding that provision in DIP financing order
8 purporting to immunize lender from Bankruptcy Code section 506(c) surcharges was unenforceable
9 and would create an improper windfall).
10
11 In addition, if unencumbered assets or a debtor's own "labor" are used, at any point in a
12 chapter 11 case, to maintain or increase the value of secured creditor collateral, unsecured creditors
13 should be able to argue, under the "equities of the case" exception set forth in section 552(b), that
14 such value inures to them, and not to the prepetition secured creditors. *See, e.g., In re Metaldyne*
15 *Corp.*, 2009 WL 2883045, at *6 (Bankr. S.D.N.Y. June 23, 2009) (holding, with regard to section
16 552, "the Court, in its discretion, declines to waive prospectively an argument that other parties in
17 interest may make."). To grant such a section 552(b) waiver as to future use of the Debtors' current
18 cash collateral, including the Escrowed Cash Collateral, without making any findings as to what
19 might now be required by the "equities of the case" is premature. *See, e.g.*, *Sprint Nextel Corp. v.*
20 *U.S. Bank Nat'l Ass'n (In re TerreStar Networks, Inc.)*, 457 B.R. 254, 272-73 (Bankr. S.D.N.Y.
21 2011) (denying request for 552(b) waiver as premature because factual record was not fully
22 developed); *In re Metaldyne Corp.*, 2009 WL 2883045, at *6 (declining to waive equities of the case
23 exception in connection with approval of debtor's use of cash collateral).
24
25 The ultimate objective of providing adequate protection to prepetition secured parties is to
26 preserve the *status quo*, not to better those parties' positions. More specifically, the purpose of
27 adequate protection is to ensure that prepetition secured lenders receive the security they bargained
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for prior to the petition date. *See In re Sonora Desert Dairy,* 2015 WL 65301, at *11 (B.A.P. 9th Cir. Jan. 15, 2015) ("In other words, adequate protection is provided to ensure that the prepetition creditor receives the value for which the creditor bargained pre-bankruptcy"); *In re Ahlers*, 794 F.2d 388, 394 (8th Cir. 1986) ("Congress intended that a debtor's offer of adequate protection should, as nearly as possible under the circumstances of the case, provide the creditor with its bargained-for rights."); *In re Park W. Hotel Corp*., 64 B.R. 1013, 1017 (Bankr. D. Mass. 1986) ("Derived from the fifth amendment protection of property interest, adequate protection . . . constitutes a legislative attempt to reconcile the competing interests of debtors, who need freedom from harassing creditors in order to effectuate reorganizations, and secured creditors, who are entitled to some measure of protection for their bargained for property interest" (internal citations omitted).)

Thus, prior to approving any adequate protection—such as section 506(b) and 552(b) waivers—a bankruptcy court must ensure that the proposed relief will not "skew the carefully designed balance of debtor and creditor protections that Congress drew in crafting Chapter 11" by approving postpetition financing on terms that "prejudice, at an early stage, the powers and rights that the Bankruptcy Code confers for the benefit of all creditors." *In re Ames Dep't. Stores, Inc.*, 115 B.R. 34, 37-38 (Bankr. S.D.N.Y. 1990); *see also In re Tenney Vill. Co.*, 104 B.R. 562, 568 (Bankr. D.N.H. 1989) (stating that postpetition financing should not be approved where effect is to "disarm the [d]ebtor of all weapons usable against it for the bankruptcy estate's benefit, place the [d]ebtor in bondage working for the Bank, seize control of the reins of reorganization, and steal a march on other creditors in numerous ways").

Here, granting waivers of sections 506(c) and 552 and marshaling principles on a going forward basis, where the Debtors' *unsecured* creditors have already been compelled to fund the costs of the liquidation of the majority of the Prepetition Secured Creditors' collateral, would add insult to injury and grant the Prepetition Secured Creditors more than they bargained for prior to the Petition

Date. It would also unfairly tilt the playing field in favor of the Prepetition Secured Creditors—who, unlike the DIP Lender earlier in these cases, are not extending any credit to the Debtors—and against unsecured creditors by taking away rights under sections 506 and 552 that the Bankruptcy Code confers for the benefit of unsecured creditors.

Further, it is significant that the Prepetition Secured Creditors could ***not*** realize the market or going concern value of their collateral without these Chapter 11 Cases. Indeed, because they are not licensed healthcare facility operators, the Prepetition Secured Creditors could not simply foreclose upon their collateral and realize the kind of value they presumably hope to realize from the Debtors' proposed disposition of assets. And, even if they were licensed and approved to take over the medical facilities, they could not foreclose upon all of the Debtors' assets due to the undisputed (and disputed) collateral issues noted above (*e.g.*, the Prepetition Secured Creditors could not recognize value from the excess MOB collateral by foreclosing inasmuch as they do not purport to have a prepetition lien on such collateral).

To be clear, the Committee strongly supports the Debtors' attempt to preserve and realize value from their assets and to preserve the thousands of related jobs. It is incredible that SGM has had the audacity to ignore this Court's orders by acting as if it is not obligated to close the purchase of assets contemplated by its asset purchase agreement with the Debtors. That said, for the Prepetition Secured Creditors to realize the value of Debtors' efforts, the Prepetition Secured Creditors should be compelled to pay for such efforts—by being subject to *potential* section 506(c) surcharge and section 552(b) allocation claims.[2]

[2] On a related point, to the extent Debtors continue to consume cash collateral, the Prepetition Secured Creditors should receive a replacement lien on assets to the extent, and only to the extent, of any diminution in the value of their collateral. "Neither the legislative history nor the [Bankruptcy] Code indicate that Congress intended the concept of adequate protection to go beyond the scope of protecting the secured claim holder from a diminution in the value of the collateral securing the debt." *In re Pine Lake Vill. Apartment Co*., 19 B.R. 819, 824 (Bankr. S.D.N.Y. 1982); *In re Orlando Trout Creek Ranch*, 80 B.R. 190, 191-92 (Bankr. N.D. Cal. 1987) (where value of collateral has appreciated during chapter 11 case, "[i]t would be overcompensation to ignore this benefit in computing any sort of adequate protection"); *In re Bluejay Props., LLC,* 512 B.R. 390 (B.A.P 10th Cir. 2014) ("[A]dequate protection is intended to protect against a decline in a creditor's security cushion; it is not intended

C. If Prepetition Secured Creditors Are Ultimately Shown to Be Undersecured, Any Postpetition Payments to Prepetition Secured Creditors Should Be Applied to Reduce Principal Amount of Their Claims

Whereas the Prepetition Secured Creditors previously contended that they were oversecured (and that their liens extended to all assets, subject only to the Committee's challenge right), such that their consent to use cash collateral was not required (and such that the Debtors should not have volunteered to waive the various estate protections afforded it by the Bankruptcy Code), it is unclear whether the Prepetition Secured Creditors are indeed oversecured. As such, to the extent any postpetition payments are made to the Prepetition Secured Creditors (for adequate protection or other purposes) and it turns out that they were not oversecured, such payments should be applied to reduce the principal balance of the Prepetition Secured Creditors' claims. *See In re Fontainebleau Las Vegas Holdings, LLC*, 2009 WL 5195775, at *5 (Bankr. S.D. Fla. Dec. 30, 2009) (if prepetition lender is determined to be undersecured, "[t]here is no question that . . . all payments made to [Lender] for its post-petition fees and expenses will reduce the Debtors' aggregate principal indebtedness to the [Lenders] dollar-for-dollar"); In re Hawaiian Telcom Commc'ns, Inc., 430 B.R. 564, 604 (Bankr. D. Haw. 2009) (same).

D. The Committee Objects to the CCO Stipulation to the Extent It Does Not Provide for the Payment of All Actual Postpetition Obligations in Full

Also of concern to the Committee is the fact that the proposed Cash Collateral Budget suggests that there may be accrued but not yet payable, or yet to be accrued, postpetition obligations that might not be paid in full under the Cash Collateral Budget. Such non-payment of administrative expenses is unacceptable. Thus, the estates must be permitted to seek to invoke section 506(c) to

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to allow a creditor to improve the security cushion that it had at the time the bankruptcy petition was filed.") One possible reading of the CCO Stipulation is that, going forward, the Prepetition Secured Creditors are to receive a replacement lien for any expenditure of their purported Cash Collateral, including the Escrowed Cash Collateral, even if such expenditure does not cause a diminution in value. This is inappropriate and cannot be authorized by the Court.

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surcharge the Prepetition Secured Creditors' collateral (as noted above) and/or the proposed Cash Collateral Budget must be amended to provide for the payment of all postpetition claims in full.

CONCLUSION

WHEREFORE, the Committee requests that the Court (i) not permit the waiver of the estates' rights under Bankruptcy Code sections 506 and 552 going forward; (ii) not permit the waiver of the estates' ability to seek marshaling going forward; (iii) conclude that, to the extent any postpetition payments are made to the Prepetition Secured Creditors and it turns out that the Prepetition Secured Creditors were not oversecured, then such payments should be applied to reduce the principal balance of the Prepetition Secured Creditors' claims; (iv) require the payment of all actual postpetition obligations in full; and grant any other relief that the Court determines is just and proper.

DATED: December 30, 2019

MILBANK LLP

/s/ Mark Shinderman
GREGORY A. BRAY
MARK SHINDERMAN
JAMES C. BEHRENS

Counsel for the Official Committee of Unsecured Creditors of Verity Health System of California, Inc., et al.

PROOF OF SERVICE OF DOCUMENT

I am over the age of 18 and not a party to this bankruptcy case or adversary proceeding. My business address is:

2029 Century Park E, 33rd Floor, Los Angeles, CA 90067.

A true and correct copy of the foregoing document entitled (*specify*): ***OFFICIAL COMMITTEE OF UNSECURED CREDITORS' OPPOSITION TO ENTRY OF FIRST AMENDED SUPPLEMENTAL CASH COLLATERAL ORDER AND STIPULATION TO (A) AMEND CASH COLLATERAL AGREEMENT AND SUPPLEMENTAL CASH COLLATERAL ORDER, (B) AUTHORIZE CONTINUED USE OF CASH COLLATERAL, (C) GRANT ADEQUATE PROTECTION, (D) MODIFY AUTOMATIC STAY, AND (E) GRANT RELATED RELIEF*** will be served or was served **(a)** on the judge in chambers in the form and manner required by LBR 5005-2(d); and **(b)** in the manner stated below:

1. TO BE SERVED BY THE COURT VIA NOTICE OF ELECTRONIC FILING (NEF): Pursuant to controlling General Orders and LBR, the foregoing document will be served by the court via NEF and hyperlink to the document. On (*date*) December 30, 2019, I checked the CM/ECF docket for this bankruptcy case or adversary proceeding and determined that the following persons are on the Electronic Mail Notice List to receive NEF transmission at the email addresses stated below:

☒ Service information continued on attached page

2. SERVED BY UNITED STATES MAIL:
On (*date*) December 30, 2019, I served the following persons and/or entities at the last known addresses in this bankruptcy case or adversary proceeding by placing a true and correct copy thereof in a sealed envelope in the United States mail, first class, postage prepaid, and addressed as follows. Listing the judge here constitutes a declaration that mailing to the judge will be completed no later than 24 hours after the document is filed.

☒ Service information continued on attached page

3. SERVED BY PERSONAL DELIVERY, OVERNIGHT MAIL, FACSIMILE TRANSMISSION OR EMAIL (state method for each person or entity served): Pursuant to FED. R. Civ. P. 5 and/or controlling LBR, on (*date*) December 30, 2019, I served the following persons and/or entities by personal delivery, overnight mail service, or (for those who consented in writing to such service method), by facsimile transmission and/or email as follows. Listing the judge here constitutes a declaration that personal delivery on, or overnight mail to, the judge will be completed no later than 24 hours after the document is filed.

☒ Service information continued on attached page

I declare under penalty of perjury under the laws of the United States that the foregoing is true and correct.

December 30, 2019	Beth Aalberts	/s/ Beth Aalberts
Date	*Printed Name*	*Signature*

SERVICE LIST
(Via NEF)

- **Alexandra Achamallah** aachamallah@milbank.com, rliubicic@milbank.com
- **Melinda Alonzo** ml7829@att.com
- **Robert N Amkraut** ramkraut@foxrothschild.com
- **Kyra E Andrassy** kandrassy@swelawfirm.com, lgarrett@swelawfirm.com;gcruz@swelawfirm.com;jchung@swelawfirm.com
- **Simon Aron** saron@wrslawyers.com
- **Lauren T Attard** lattard@bakerlaw.com, agrosso@bakerlaw.com
- **Allison R Axenrod** allison@claimsrecoveryllc.com
- **Cristina E Bautista** cristina.bautista@kattenlaw.com, ecf.lax.docket@kattenlaw.com
- **James Cornell Behrens** jbehrens@milbank.com, gbray@milbank.com;mshinderman@milbank.com;dodonnell@milbank.com;jbrewster@milbank.com;JWeber@milbank.com
- **Ron Bender** rb@lnbyb.com
- **Bruce Bennett** bbennett@jonesday.com
- **Peter J Benvenutti** pbenvenutti@kellerbenvenutti.com, pjbenven74@yahoo.com
- **Leslie A Berkoff** lberkoff@moritthock.com, hmay@moritthock.com
- **Steven M Berman** sberman@slk-law.com
- **Stephen F Biegenzahn** efile@sfblaw.com
- **Karl E Block** kblock@loeb.com, jvazquez@loeb.com;ladocket@loeb.com;kblock@ecf.courtdrive.com
- **Dustin P Branch** branchd@ballardspahr.com, carolod@ballardspahr.com;hubenb@ballardspahr.com
- **Michael D Breslauer** mbreslauer@swsslaw.com, wyones@swsslaw.com;mbreslauer@ecf.courtdrive.com;wyones@ecf.courtdrive.com
- **Chane Buck** cbuck@jonesday.com
- **Lori A Butler** butler.lori@pbgc.gov, efile@pbgc.gov
- **Howard Camhi** hcamhi@ecjlaw.com, tcastelli@ecjlaw.com;amatsuoka@ecjlaw.com
- **Barry A Chatz** barry.chatz@saul.com, jurate.medziak@saul.com
- **Shirley Cho** scho@pszjlaw.com
- **Shawn M Christianson** cmcintire@buchalter.com, schristianson@buchalter.com
- **Louis J. Cisz** lcisz@nixonpeabody.com, jzic@nixonpeabody.com
- **Leslie A Cohen** leslie@lesliecohenlaw.com, jaime@lesliecohenlaw.com;olivia@lesliecohenlaw.com
- **Marcus Colabianchi** mcolabianchi@duanemorris.com
- **Kevin Collins** kevin.collins@btlaw.com, Kathleen.lytle@btlaw.com
- **Joseph Corrigan** Bankruptcy2@ironmountain.com
- **David N Crapo** dcrapo@gibbonslaw.com, elrosen@gibbonslaw.com
- **Mariam Danielyan** md@danielyanlawoffice.com, danielyan.mar@gmail.com
- **Brian L Davidoff** bdavidoff@greenbergglusker.com, calendar@greenbergglusker.com;jking@greenbergglusker.com
- **Aaron Davis** aaron.davis@bryancave.com, kat.flaherty@bryancave.com
- **Lauren A Deeb** lauren.deeb@nelsonmullins.com, maria.domingo@nelsonmullins.com
- **Daniel Denny** ddenny@milbank.com
- **Anthony Dutra** adutra@hansonbridgett.com
- **Kevin M Eckhardt** kevin.eckhardt@gmail.com, keckhardt@hunton.com
- **Lei Lei Wang Ekvall** lekvall@swelawfirm.com, lgarrett@swelawfirm.com;gcruz@swelawfirm.com;jchung@swelawfirm.com
- **David K Eldan** david.eldan@doj.ca.gov, teresa.depaz@doj.ca.gov
- **Andy J Epstein** taxcpaesq@gmail.com
- **Richard W Esterkin** richard.esterkin@morganlewis.com
- **Christine R Etheridge** christine.etheridge@ikonfin.com
- **M Douglas Flahaut** flahaut.douglas@arentfox.com
- **Michael G Fletcher** mfletcher@frandzel.com, sking@frandzel.com

- **Joseph D Frank** jfrank@fgllp.com, mmatlock@fgllp.com;csmith@fgllp.com;jkleinman@fgllp.com;csucic@fgllp.com
- **William B Freeman** bill.freeman@kattenlaw.com, nicole.jones@kattenlaw.com,ecf.lax.docket@kattenlaw.com
- **John-Patrick M Fritz** jpf@lnbyb.com, JPF.LNBYB@ecf.inforuptcy.com
- **Eric J Fromme** efromme@tocounsel.com, lchapman@tocounsel.com;sschuster@tocounsel.com
- **Amir Gamliel** amir-gamliel-9554@ecf.pacerpro.com, cmallahi@perkinscoie.com;DocketLA@perkinscoie.com
- **Jeffrey K Garfinkle** jgarfinkle@buchalter.com, docket@buchalter.com;dcyrankowski@buchalter.com
- **Thomas M Geher** tmg@jmbm.com, bt@jmbm.com;fc3@jmbm.com;tmg@ecf.inforuptcy.com
- **Lawrence B Gill** lgill@nelsonhardiman.com, rrange@nelsonhardiman.com;mmarkwell@nelsonhardiman.com
- **Paul R. Glassman** pglassman@sycr.com
- **Matthew A Gold** courts@argopartners.net
- **Eric D Goldberg** eric.goldberg@dlapiper.com, eric-goldberg-1103@ecf.pacerpro.com
- **Marshall F Goldberg** mgoldberg@glassgoldberg.com, jbailey@glassgoldberg.com
- **Richard H Golubow** rgolubow@wcghlaw.com, pj@wcghlaw.com;jmartinez@wcghlaw.com;Meir@virtualparalegalservices.com
- **David M. Guess** guessd@gtlaw.com
- **Anna Gumport** agumport@sidley.com
- **Melissa T Harris** harris.melissa@pbgc.gov, efile@pbgc.gov
- **James A Hayes** jhayes@zinserhayes.com, jhayes@jamesahayesaplc.com
- **Michael S Held** mheld@jw.com
- **Lawrence J Hilton** lhilton@onellp.com, lthomas@onellp.com,info@onellp.com,rgolder@onellp.com,lhyska@onellp.com,nlichtenberger@onellp.com
- **Robert M Hirsh** Robert.Hirsh@arentfox.com
- **Florice Hoffman** fhoffman@socal.rr.com, floricehoffman@gmail.com
- **Lee F Hoffman** leehoffmanjd@gmail.com, lee@fademlaw.com
- **Michael Hogue** hoguem@gtlaw.com, SFOLitDock@gtlaw.com;navarrom@gtlaw.com
- **Matthew B Holbrook** mholbrook@sheppardmullin.com, mmanns@sheppardmullin.com
- **David I Horowitz** david.horowitz@kirkland.com, keith.catuara@kirkland.com;terry.ellis@kirkland.com;elsa.banuelos@kirkland.com;ivon.granados@kirkland.com
- **Brian D Huben** hubenb@ballardspahr.com, carolod@ballardspahr.com
- **Joan Huh** joan.huh@cdtfa.ca.gov
- **Benjamin Ikuta** bikuta@hml.law
- **Lawrence A Jacobson** laj@cohenandjacobson.com
- **John Mark Jennings** johnmark.jennings@kutakrock.com, mary.clark@kutakrock.com
- **Monique D Jewett-Brewster** mjb@hopkinscarley.com, eamaro@hopkinscarley.com
- **Crystal Johnson** M46380@ATT.COM
- **Gregory R Jones** gjones@mwe.com, rnhunter@mwe.com
- **Jeff D Kahane** jkahane@duanemorris.com, dmartinez@duanemorris.com
- **Steven J Kahn** skahn@pszyjw.com
- **Cameo M Kaisler** salembier.cameo@pbgc.gov, efile@pbgc.gov
- **Ivan L Kallick** ikallick@manatt.com, ihernandez@manatt.com
- **Ori Katz** okatz@sheppardmullin.com, cshulman@sheppardmullin.com;ezisholtz@sheppardmullin.com;lsegura@sheppardmullin.com
- **Payam Khodadadi** pkhodadadi@mcguirewoods.com, dkiker@mcguirewoods.com
- **Christian T Kim** ckim@dumas-law.com, ckim@ecf.inforuptcy.com
- **Jane Kim** jkim@kellerbenvenutti.com
- **Monica Y Kim** myk@lnbrb.com, myk@ecf.inforuptcy.com
- **Gary E Klausner** gek@lnbyb.com
- **David A Klein** david.klein@kirkland.com
- **Nicholas A Koffroth** nick.koffroth@dentons.com, chris.omeara@dentons.com
- **Joseph A Kohanski** jkohanski@bushgottlieb.com, kprestegard@bushgottlieb.com

- **Jeffrey S Kwong** jsk@lnbyb.com, jsk@ecf.inforuptcy.com
- **Darryl S Laddin** bkrfilings@agg.com
- **Robert S Lampl** advocate45@aol.com, rlisarobinsonr@aol.com
- **Richard A Lapping** richard@lappinglegal.com
- **Paul J Laurin** plaurin@btlaw.com, slmoore@btlaw.com;jboustani@btlaw.com
- **Nathaniel M Leeds** nathaniel@mitchelllawsf.com, sam@mitchelllawsf.com
- **David E Lemke** david.lemke@wallerlaw.com, chris.cronk@wallerlaw.com;Melissa.jones@wallerlaw.com;cathy.thomas@wallerlaw.com
- **Lisa Lenherr** llenherr@wendel.com, bankruptcy@wendel.com
- **Elan S Levey** elan.levey@usdoj.gov, louisa.lin@usdoj.gov
- **Tracy L Mainguy** bankruptcycourtnotices@unioncounsel.net, tmainguy@unioncounsel.net
- **Samuel R Maizel** samuel.maizel@dentons.com, alicia.aguilar@dentons.com;docket.general.lit.LOS@dentons.com;tania.moyron@dentons.com;kathryn.howard@dentons.com;joan.mack@dentons.com;derry.kalve@dentons.com
- **Alvin Mar** alvin.mar@usdoj.gov, dare.law@usdoj.gov
- **Craig G Margulies** Craig@MarguliesFaithlaw.com, Victoria@MarguliesFaithlaw.com;Helen@MarguliesFaithlaw.com
- **Hutchison B Meltzer** hutchison.meltzer@doj.ca.gov, Alicia.Berry@doj.ca.gov
- **John J Menchaca (TR)** jmenchaca@menchacacpa.com, ca87@ecfcbis.com;igaeta@menchacacpa.com
- **Christopher Minier** becky@ringstadlaw.com, arlene@ringstadlaw.com
- **John A Moe** john.moe@dentons.com, glenda.spratt@dentons.com
- **Susan I Montgomery** susan@simontgomerylaw.com, assistant@simontgomerylaw.com;simontgomerylawecf.com@gmail.com;montgomerysr71631@notify.bestcase.com
- **Monserrat Morales** Monsi@MarguliesFaithLaw.com, Victoria@MarguliesFaithLaw.com;Helen@marguliesfaithlaw.com
- **Kevin H Morse** kmorse@clarkhill.com, blambert@clarkhill.com
- **Marianne S Mortimer** mmartin@jmbm.com
- **Tania M Moyron** tania.moyron@dentons.com, chris.omeara@dentons.com;nick.koffroth@dentons.com
- **Alan I Nahmias** anahmias@mbnlawyers.com, jdale@mbnlawyers.com
- **Akop J Nalbandyan** jnalbandyan@LNtriallawyers.com, cbautista@LNtriallawyers.com
- **Jennifer L Nassiri** jennifernassiri@quinnemanuel.com
- **Charles E Nelson** nelsonc@ballardspahr.com, wassweilerw@ballardspahr.com
- **Sheila Gropper Nelson** shedoesbklaw@aol.com
- **Mark A Neubauer** mneubauer@carltonfields.com, mlrodriguez@carltonfields.com;smcloughlin@carltonfields.com;schau@carltonfields.com;NDunn@carltonfields.com;ecfla@carltonfields.com
- **Fred Neufeld** fneufeld@sycr.com, tingman@sycr.com
- **Nancy Newman** nnewman@hansonbridgett.com, ajackson@hansonbridgett.com;calendarclerk@hansonbridgett.com
- **Bryan L Ngo** bngo@fortislaw.com, BNgo@bluecapitallaw.com;SPicariello@fortislaw.com;JNguyen@fortislaw.com;JNguyen@bluecapitallaw.com
- **Abigail V O'Brient** avobrient@mintz.com, docketing@mintz.com;DEHashimoto@mintz.com;nleali@mintz.com;ABLevin@mintz.com;GJLeon@mintz.com
- **John R OKeefe** jokeefe@metzlewis.com, slohr@metzlewis.com
- **Scott H Olson** solson@vedderprice.com, jcano@vedderprice.com,jparker@vedderprice.com;scott-olson-2161@ecf.pacerpro.com,ecfsfdocket@vedderprice.com
- **Giovanni Orantes** go@gobklaw.com, gorantes@orantes-law.com,cmh@gobklaw.com,gobklaw@gmail.com,go@ecf.inforuptcy.com;orantesgr89122@notify.bestcase.com
- **Keith C Owens** kowens@venable.com, khoang@venable.com
- **R Gibson Pagter** gibson@ppilawyers.com, ecf@ppilawyers.com;pagterrr51779@notify.bestcase.com
- **Paul J Pascuzzi** ppascuzzi@ffwplaw.com
- **Lisa M Peters** lisa.peters@kutakrock.com, marybeth.brukner@kutakrock.com

- **Christopher J Petersen** cjpetersen@blankrome.com, gsolis@blankrome.com
- **Mark D Plevin** mplevin@crowell.com, cromo@crowell.com
- **Steven G. Polard** spolard@ch-law.com, calendar-lao@rmkb.com;melissa.tamura@rmkb.com;anthony.arriola@rmkb.com
- **David M Powlen** david.powlen@btlaw.com, pgroff@btlaw.com
- **Christopher E Prince** cprince@lesnickprince.com, jmack@lesnickprince.com;cprince@ecf.courtdrive.com
- **Lori L Purkey** bareham@purkeyandassociates.com
- **William M Rathbone** wrathbone@grsm.com, jmydlandevans@grsm.com;sdurazo@grsm.com
- **Jason M Reed** Jason.Reed@Maslon.com
- **Michael B Reynolds** mreynolds@swlaw.com, kcollins@swlaw.com
- **J. Alexandra Rhim** arhim@hrhlaw.com
- **Emily P Rich** erich@unioncounsel.net, bankruptcycourtnotices@unioncounsel.net
- **Robert A Rich** , candonian@huntonak.com
- **Lesley A Riis** lriis@dpmclaw.com
- **Debra Riley** driley@allenmatkins.com
- **Jason E Rios** jrios@ffwplaw.com
- **Julie H Rome-Banks** julie@bindermalter.com
- **Mary H Rose** mrose@buchalter.com
- **Gregory A Rougeau** grougeau@brlawsf.com
- **Megan A Rowe** mrowe@dsrhealthlaw.com, lwestoby@dsrhealthlaw.com
- **Nathan A Schultz** nschultz@goodwinlaw.com
- **Mark A Serlin** ms@swllplaw.com, mor@swllplaw.com
- **Seth B Shapiro** seth.shapiro@usdoj.gov
- **David B Shemano** dshemano@shemanolaw.com
- **Joseph Shickich** jshickich@riddellwilliams.com
- **Mark Shinderman** mshinderman@milbank.com, dmuhrez@milbank.com;dlbatie@milbank.com
- **Rosa A Shirley** rshirley@nelsonhardiman.com, ksherry@nelsonhardiman.com;lgill@nelsonhardiman.com;rrange@nelsonhardiman.com
- **Kyrsten Skogstad** kskogstad@calnurses.org, rcraven@calnurses.org
- **Michael St James** ecf@stjames-law.com
- **Andrew Still** astill@swlaw.com, kcollins@swlaw.com
- **Jason D Strabo** jstrabo@mwe.com, cfuraha@mwe.com
- **Sabrina L Streusand** Streusand@slollp.com
- **Ralph J Swanson** ralph.swanson@berliner.com, sabina.hall@berliner.com
- **Michael A Sweet** msweet@foxrothschild.com, swillis@foxrothschild.com;pbasa@foxrothschild.com
- **James Toma** james.toma@doj.ca.gov, teresa.depaz@doj.ca.gov
- **Gary F Torrell** gtorrell@health-law.com
- **United States Trustee (LA)** ustpregion16.la.ecf@usdoj.gov
- **Cecelia Valentine** cecelia.valentine@nlrb.gov
- **Jason Wallach** jwallach@ghplaw.com, g33404@notify.cincompass.com
- **Kenneth K Wang** kenneth.wang@doj.ca.gov, Jennifer.Kim@doj.ca.gov;Stacy.McKellar@doj.ca.gov;yesenia.caro@doj.ca.gov
- **Phillip K Wang** phillip.wang@rimonlaw.com, david.kline@rimonlaw.com
- **Sharon Z. Weiss** sharon.weiss@bclplaw.com, raul.morales@bclplaw.com
- **Adam G Wentland** awentland@tocounsel.com, lkwon@tocounsel.com
- **Latonia Williams** lwilliams@goodwin.com, bankruptcy@goodwin.com
- **Michael S Winsten** mike@winsten.com
- **Jeffrey C Wisler** jwisler@connollygallagher.com, dperkins@connollygallagher.com
- **Neal L Wolf** nwolf@hansonbridgett.com, calendarclerk@hansonbridgett.com,lchappell@hansonbridgett.com
- **Hatty K Yip** hatty.yip@usdoj.gov, dare.law@usdoj.gov;kelly.l.morrison@usdoj.gov;kenneth.g.lau@usdoj.gov
- **Andrew J Ziaja** aziaja@leonardcarder.com, sgroff@leonardcarder.com;msimons@leonardcarder.com;lbadar@leonardcarder.com
- **Rose Zimmerman** rzimmerman@dalycity.org

SERVICE LIST
(Via First Class Mail)

Verity Health System of California, Inc.
2040 E. Mariposa Avenue
El Segundo, CA 90245

Samuel R. Maizel
Dentons US LLP
601 South Figueroa Street
Suite 2500
Los Angeles, CA 90017

SERVICE LIST
(Via Personal Delivery)

The Honorable Ernest M. Robles
United States Bankruptcy Court
Central District of California
Edward R. Roybal Federal Building and Courthouse
255 E. Temple Street, Suite 1560/Courtroom 1568
Los Angeles, CA 90012-3300

SERVICE LIST
(Via Email)

Attorneys for Chapter 11 Debtors and Debtors in Possession
Samuel R. Maizel – samuel.maizel@dentons.com
John A. Moe, II – john.moe@dentons.com
Tania M. Moyron – tania.moyron@dentons.com
Nick Koffroth – nick.koffroth@dentons.com

UMB Bank, N.A., c/o Mintz
Daniel Bleck – DSBleck@mintz.com
Paul Ricotta – PRicotta@mintz.com

Wells Fargo Bank, N.A., c/o Mintz
Daniel Bleck – DSBleck@mintz.com
Paul Ricotta – PRicotta@mintz.com

U.S. Bank, N.A., c/o Maslon LLP & McDermott Will & Emery
Clark Whitmore – clark.whitemore@maslon.com
Nathan F. Coco – ncoco@mwe.com