Docket #4225 Date Filed: 3/6/2020

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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
☐ Affects Verity Health System of California, Inc.
☐ Affects O'Connor Hospital
☐ Affects Saint Louise Regional Hospital
☐ Affects St. Francis Medical Center
☐ Affects St. Vincent Medical Center
☐ Affects Seton Medical Center
☐ Affects O'Connor Hospital Foundation
☐ Affects Saint Louise Regional Hospital Foundation
☐ Affects St. Francis Medical Center of Lynwood Foundation
☐ Affects St. Vincent Foundation
☐ Affects St. Vincent Dialysis Center, Inc.
☐ Affects Seton Medical Center Foundation
☐ Affects Verity Business Services
☐ Affects Verity Medical Foundation
☐ Affects Verity Holdings, LLC
☐ Affects De Paul Ventures, LLC
☐ Affects 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. Judge Ernest M. Robles

JOINT RESPONSE OF PREPETITION SECURED CREDITORS TO OFFICIAL COMMITTEE OF UNSECURED CREDITORS' OPPOSITION TO THIRD AMENDED SUPPLEMENTAL CASH COLLATERAL STIPULATION

[RELATED TO DOCKET NO. 4199]

Hearing Date: March 11, 2020

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UMB Bank, N.A., as successor master trustee, Wells Fargo Bank, National Association, as indenture trustee for the series 2005 revenue bonds, U.S. Bank, National Association, as indenture trustee for both the 2015 notes and the 2017 notes, Verity MOB Financing, LLC, and Verity MOB Financing II, LLC (collectively, the "Prepetition Secured Creditors")[1] hereby file this response (the "Response") to the *Official Committee of Unsecured Creditors' (1) Opposition to Third Amended Supplemental Cash Collateral Stipulation; (2) Objection to the Order Thereon; and (3) Request for Hearing; Declaration of James C. Behrens in Support thereof*, dated March 2, 2020 [Docket No. 4199] (the "Objection") filed by the Official Committee of Unsecured Creditors of Verity Health System of California, Inc., *et al.* (the "Committee"), and in support hereof, respectfully state as follows:

PRELIMINARY STATEMENT

If the Committee's Objection is sustained, it would immediately halt the Debtors' ongoing efforts to sell their hospitals, result in an almost immediate cessation of their hospital operations, put the health and well-being of the Debtors' patients in jeopardy, and eliminate any potential recoveries to the Committee's own constituents which might arise from the future sale of the Debtors' assets in the ordinary course. The Committee surely knows that the Prepetition Secured Creditors cannot be compelled to write a blank check to the estate and, literally, guaranty the payment of any and all administrative claims in these cases. It also knows that the Prepetition Secured Creditors will not voluntarily agree to such a guaranty and, given the Debtors' admitted ongoing, substantial cash flow losses, the Debtors would not be entitled to the use of cash collateral without the voluntary agreement of the Prepetition Secured Creditors. Thus, the Committee's Objection essentially threatens Armageddon – complete and immediate cessation of the use of any cash collateral, leading to an abrupt and chaotic shut down of the Debtors' operations, and the liquidation of their assets at fire sale prices.

[1] Capitalized terms used but not defined herein shall have the meanings ascribed to them in the *Stipulation to (A) Amend the Second Amended Supplemental Cash Collateral Order, (B) Authorize Continued Use of Cash Collateral, (C) Grant Adequate Protection, (D) Modify Automatic Stay, and (E) Grant Related Relief*, dated February 28, 2020 [Docket No. 4184] (the "Stipulation").

The Debtors have been crystal clear from the very first day of these cases that their sole goal was, and continues to be the orderly sale of their hospitals, each of which is encumbered by liens in favor of one or more of the Prepetition Secured Creditors. The Debtors successfully sold St. Louise Medical Center and O'Connor Hospital as going concerns, and are currently in the midst of intensive and costly efforts to sell St. Francis Medical Center and the real estate at St. Vincent Medical Center, following the refusal of SGM to consummate the purchase of the Debtors' other hospital assets. The Debtors, the Committee and the Prepetition Secured Creditors have consensually agreed on the use of cash collateral on four (4) different occasions, spanning one and one-half years, for the express purpose of facilitating those sales. The Debtors are significantly cash-flow negative, so that, without the use of cash collateral, the completed sales would never have occurred, and the pending sale efforts could not continue. The terms of the parties' cash collateral agreements have been substantially identical each time, and each time the express purpose for the use of cash collateral has been to allow the Debtors to sell or otherwise dispose of their hospitals in the ordinary course in order to maximize value. Never once has the Committee threatened to force the Debtors into liquidation if there was not a guaranty of the payment of any and all administrative claims.

Apart from the fact that the Objection seeks an irrational and destructive result, it is also devoid of any legal or factual support. The basis for the Committee's unprecedented argument is that, if a secured lender obtains Section 506(c) and Section 552(b) waivers as part of its adequate protection package, it may not consent to the use of its cash collateral unless it also guaranties payment of any and all administrative expenses in full. This position is directly contradicted by the priorities set forth in the Bankruptcy Code. The Committee has not, and cannot cite to any authority supporting its theoretical policy argument for a very simple reason: there isn't any. There is no dispute that secured creditors are entitled to assert the legal priority of their prepetition and postpetition liens, and that such priority comes ahead of unsecured creditors, including administrative creditors. If the Committee wishes to make policy arguments or seek a fundamental change in the law, this is not the proper forum or venue.

Even if the Committee's philosophical assertion that the Prepetition Secured Creditors must "pay their freight" were a bona fide legal position (it is not), its theory would still be meritless under the facts of this case. The Prepetition Secured Creditors have voluntarily agreed to allow more than one-half billion dollars of their cash collateral to be used by the Debtors since the Petition Date, including allowing the Debtors to drain virtually all of the cash proceeds arising from the only sales that have actually closed in these cases, *viz*., the sale of St. Louise Medical Center and O'Connor Hospital. The Prepetition Secured Creditors have, in fact, paid the "freight" of these cases. Moreover, the Committee's myopic, one-sided view fails to recognize that, absent the willingness of the Prepetition Secured Creditors to allow the use of their cash collateral, the probability of any recovery for other creditors, such as unsecured creditors, would likely be *de minimus*.

The Committee's Objection is also premature. It is too soon to know whether or not there will be sufficient unencumbered sale proceeds to pay administrative claims. The Committee's concern may never become an issue, and it is unnecessary for this Court to make declaratory rulings at this time. Out of the six (6) medical facilities which comprised the Debtors at the beginning of these cases, only two (2) have been sold so far. The Debtors are in the process of selling their remaining facilities, and it is highly probable that those efforts will include one or more auctions among many interested buyers. At this time, no one can predict the result of those auctions. In addition, any requirement to pay administrative expenses in full arises upon confirmation of a plan of reorganization. No plan has even been proposed in this case. Accordingly, it is currently unknown if the Committee's concern will ever materialize; such concern is not before the Court today; and it is certainly not ripe for immediate decision.

Last, the Committee argues that, because this Court exercised its discretion at the beginning of these cases to grant waivers of Section 506(c) and Section 552(b) as part of the Prepetition Secured Creditors' adequate protection package, the Prepetition Secured Creditors are now required to guaranty full payment of all present and future administrative claims. Bankruptcy law does not require that there be any substitute for such waivers – if so, such waivers would be ineffective and illusory. The Prepetition Secured Creditors are entitled to the protections afforded

to them by the Court in these cases before the outcome of the sale process could have been known. The Objection is yet another attempt to attack the Final DIP Order, which was entered almost one and one-half years ago. In fact, the Committee has appealed the granting of such waivers, which appeal was denied at the District Court level but which the Committee has further appealed to the Ninth Circuit. The Committee is not entitled to have it both ways by arguing that the existence of such waivers somehow requires this Court to sustain its Objection, while at the same time pursuing an appeal seeking to overturn such waivers.

RESPONSE

I. The Committee Cannot Dictate the Terms of a Voluntary and Consensual Agreement Between the Prepetition Secured Creditors and the Debtors With Respect to the Use of Cash Collateral.

The Stipulation is a consensual agreement between the Debtors and the Prepetition Secured Creditors which will allow the Debtors to access cash collateral in order to continue to operate and proceed with an orderly sale process. The Committee seeks to condition approval of this consensual arrangement on a guaranty by the Prepetition Secured Creditors that they will satisfy all allowed administrative claims. Nothing in the law empowers the Committee to dictate the terms of a voluntary and consensual agreement between the Prepetition Secured Creditors and the Debtors. There is absolutely no basis in law for the Committee to force the Prepetition Secured Creditors to enter into an unlimited guaranty against their will, which would be the functional equivalent of compelling the Prepetition Secured Creditors to make an involuntary loan, nor is there any authority which would allow the equivalent of an involuntary carve-out from the collateral of the Prepetition Secured Creditors in order to pay administrative claims.

The Prepetition Secured Creditors would not have agreed to allow the Debtors to continue to use their cash collateral on any terms other than those contained in the Stipulation. For the avoidance of doubt, the Prepetition Secured Creditors *do not* consent to provide an unlimited guaranty that is tantamount to writing a blank check to the Committee and its professionals. The Prepetition Secured Creditors believe that, absent the Prepetition Secured Creditors' consent, the Debtors will not be able to provide the required adequate protection to justify use of the Prepetition

Secured Creditors' cash collateral. Thus, if the Objection were sustained, it would likely result in the almost immediate and chaotic cessation of the Debtors' hospital and patient care activities, the layoff of hundreds or thousands of employees, and the liquidation of the Debtors' assets at fire sale prices. This doomsday scenario is not in the best interests of any party in these cases, the Debtors' patients, or the Committee and its own constituents, and can be avoided by overruling the Objection.

One can only surmise that the Committee is fully cognizant of the ramifications of achieving "success" on its Objection, and has decided to engage in a high stakes "game of chicken" to see whether or not this Court and the other parties are willing to blink. It is unfortunate that the Committee has chosen to play games when the health and well-being of the Debtors' patients may be at stake.

II. The Committee's Argument Is Merely an Attempt to Argue for a Theoretical Change in Bankruptcy Law and Policy, Is Contrary to Existing Law, and Otherwise Lacks Any Support in the Bankruptcy Code or Case Law

The Committee takes the novel position that, if a secured lender obtains the benefit of a waiver of Section 506(c) and Section 552(b) as part of its original adequate protection package, that secured lender is prohibited from consenting to the use of its cash collateral unless it also guaranties full payment of any and all administrative expenses. None of the cases cited by the Committee stands for this proposition.[2] There is no support in the Bankruptcy Code, case law, or custom and practice for this position. In fact, the opposite is true. It is beyond dispute that the claim of a secured creditor has legal priority over the claims of unsecured creditors, including administrative creditors. *See, e.g., Hartford Underwriters Ins. Co., v. Union Planters Bank, N.A.,*

[2] The Committee's citations solely include (a) cases regarding the operation of Section 506(c) or the propriety of waivers of Section 506(c) in financing orders, to wit, *Precision Steel Shearing v. Fremont Fin. Corp. (In re Visual Indus., Inc.,)*, 57 F.3d 321, 325 (3d Cir. 1995) (affirming lower court's denial of motion to surcharge secured lender's collateral pursuant to Section 506(c)); *In re Codesco, Inc.*, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) (denying motion pursuant to Section 506(c) to surcharge the creditor's collateral); *In re Proto-Specialties, Inc.*, 43 B.R. 81, 83 (Bankr. D. Ariz. 1984) (determining an award under Section 506(c)); *In re Metaldyne Corp.*, Case No. 09-131412 (MG), 2009 Bankr. LEXIS 1533 (Bankr. S.D.N.Y. Jun. 23, 2009) (overruling committee's objection to Section 506(c) waiver because lenders were funding the bankruptcy cases), and (b) cases pertaining to the approval of postpetition financing arrangements, to wit, *In re Def. Drug Stores, Inc.*, 145 B.R. 312, 317 (B.A.P. 9th Cir. 1992)(affirming bankruptcy court's order denying motion to disallow enhancement fee awarded to postpetition lender in financing order); *In re Tenney Vill. Co., Inc.*, 104 B.R. 562, 568 (Bankr. D.N.H. 1989) (denying approval for postpetition financing agreement which would improperly cancel all prior security interests without providing adequate protection to prepetition lenders).

530 U.S. 1,5 (2000) (noting that although administrative expenses are entitled to priority over unsecured claims, they do not have priority over secured claims). Therefore, there is no general rule that requires a secured creditor to ensure that, if its collateral is sold in a bankruptcy case, it must also ensure that all administrative claims are paid in full regardless whether its own secured claim is satisfied. The Bankruptcy Code contains certain narrow exceptions to the rule that secured claims take priority over unsecured claims, *e.g.*, Section 506(c) and Section 552(b), but the assertion by the Committee that there exists some overarching requirement that a secured creditor must guaranty payment of all administrative claims as a precondition to the sale of its collateral in a bankruptcy case is simply wrong as a matter of law. In fact, the logical extension of the Committee's argument is that Sections 506(c) and 552(b) are superfluous since, according to the Committee, all secured creditors must be the guarantor of all administrative claims as a prerequisite to the sale of their collateral. In actuality, the Committee is just complaining that it wishes that it could change the bankruptcy laws.

III. Regardless of Whether They Have Any Obligation to Do So, the Prepetition Secured Creditors Are, in Fact, Funding These Cases Through the Consensual Use of Their Cash Collateral

The Committee accuses the Prepetition Secured Creditors of not "paying their freight" in return for the sale of their collateral. As noted above, there is no such legal concept and no such legal obligation. Nevertheless, the Committee's accusation is simply wrong as a matter of fact.

Throughout the entirety of these cases, the Prepetition Secured Creditors have worked with the Debtors in good faith to come to a series of consensual agreements allowing the Debtors to use cash collateral. The Stipulation represents the fourth such agreement between the parties. Even after the unfortunate termination of the SGM sale, which significantly increased the uncertainty of the recovery for the Prepetition Secured Creditors, the Prepetition Secured Creditors continued to enter into cash collateral agreements on substantially the same terms as before. The Committee, on the other hand, has decided to file the Objection.

Even by conservative estimates, the Prepetition Secured Creditors have voluntarily consented to the use of more than one-half billion dollars of their cash collateral, including

- **$86 million**: the Prepetition Secured Creditors consented to be primed by the DIP Lender pursuant to the Final DIP Order, which priming loan was subsequently satisfied from collateral sale proceeds in the amount of $86 million pursuant to the Supplemental Cash Collateral Order; [3]

- **$46 million**: pursuant to the Final DIP Order, the Prepetition Secured Creditors consented to the use of the cash held as of the Petition Date in the bank accounts of the members of their obligated group under the Master Indenture;

- **$219 million:** pursuant to the Final DIP Order, the Prepetition Secured Creditors consented to the use of net accounts receivable outstanding as of the Petition Date;[4] and

- **$176 million**: the amount of the Debtors' Sales Proceeds (as defined in the Final DIP Order) that has been expended to date pursuant to the Supplemental Cash Collateral Order.[5]

In total, the Prepetition Secured Creditors have "paid the freight" in these cases in an aggregate amount of at least $527 million. It is simply not true that the Prepetition Secured Creditors have been the beneficiary of a free ride while benefitting from the sale of their collateral. The Prepetition Secured Creditors have funded, and continue to fund, the administration of these cases through the budget attached to the Stipulation, even though their recovery has become less certain.

The Committee's unfounded accusation is even more remarkable in light of the fact that the Committee has challenged certain aspects of the liens of the Prepetition Secured Creditors.[6] If such Lien Challenge has any merit – it does not – the Committee is effectively demanding that the Prepetition Secured Creditors finance their adversary's litigation costs.[7] Once again, to accuse the Prepetition Secured Creditors of getting the benefits without sharing any of the costs is simply ignoring the facts.

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[3] *See Debtors' Notice of Motion and Motion for Entry of an Order (A) Authorizing the Debtors to Use Cash Collateral and (B) Granting Adequate Protection to Prepetition Secured Creditors; Memorandum of Points and Authorities; Declaration of Anita Chou in Support Thereof,* dated August 28, 2019 [Docket No. 2962] at ¶ 28.

[4] *See 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; Memorandum of Points and Authorities in Support Thereof; Declaration of Anita Chou in Support Thereof,* dated August 31, 2018 [Docket No. 31] at ¶ 30.

[5] The Escrow Deposit Account Balances (as defined in the DIP Order) initially contained more than $187 million. *See* Supplemental Cash Collateral Order at ¶ F. The current balance in these accounts is approximately $11 million.

[6] On June 13, 2019, the Committee commenced Adversary Proceeding No. 2:19-ap-19-01166-ER against UMB Bank, N.A., and Adversary Proceeding No. 2:19-ap-19-01165-ER against US Bank, National Association (collectively, the "Lien Challenge").

[7] The Prepetition Secured Creditors reserve all rights to object to professional fees, and note that, based just on the fee applications filed to date, the amount of cash collateral used to prosecute the Lien Challenge and the Ninth Circuit appeal far exceeds the amount permitted by the Final DIP Order. *See* Final DIP Order at ¶ 5(e).

IV. The Committee's Objection is Premature

The Committee's Objection can also be overruled simply on the grounds that it is premature. It is too soon to determine whether there will be sufficient sale proceeds to pay administrative claims in full. Out of the six (6) medical facilities which comprised the Debtors at the beginning of these cases, only two (2) have been sold, and the Debtors are in the process of disposing of the remainder. At least two of the remaining facilities will likely involve auction sales among a number of interested buyers. No one can predict the amount of net proceeds that will result from those auctions, and whether there will be sufficient sale proceeds to pay the Prepetition Secured Creditors and all administrative claims. Ironically, if the Objection is sustained, the ordinary course sales currently scheduled will not occur, thereby ensuring that administrative claims will not be paid in full. Procedurally, the requirement to pay administrative expenses in full only arises at the end of the case, after all of the assets have been liquidated, and a plan of reorganization is confirmed. *See* 11 U.S.C. § 1129 (a)(9)(A) (requiring that holders of administrative claims be paid cash equal to the allowed amount of such claim on the effective date of the plan, unless the holder of a particular claim agrees to different treatment). No plan has even been proposed. Thus, it is currently unknown if the Committee's concern will ever materialize, and the Court need not speculate today.

V. The Committee's Objection Is a Collateral Attack on the Final DIP Order, and an End Run Around the Appeal Pending Before the Ninth Circuit

The Committee argues that its Objection should be sustained because this Court approved a waiver of claims under Sections 506(c) and 552(b) as part of the adequate protection package afforded the Prepetition Secured Creditors in the Final DIP Order.[8] The Committee appealed the Final DIP Order to the extent it contained the waivers. The District Court affirmed this Court's order, and the Committee has further appealed to the Ninth Circuit. The Committee argues that its demand that the Prepetition Secured Creditors expressly guaranty the payment of any and all administrative claims is required as a substitute for such waivers. There is no law that requires any substitute for such waivers, otherwise, such waivers would be worthless and illusory.

[8] *See* Final DIP Order at ¶ 5(e).

Moreover, the Committee is not entitled to have it both ways by arguing that the existence of such waivers requires this Court to sustain its Objection, while at the same time pursuing an appeal seeking to nullify the existence of such waivers.

Alternatively, the Committee's argument that it is entitled to a substitute for the waivers can be rejected on the grounds that it is nothing more than a thinly veiled collateral attack on the Final DIP Order, which was entered almost one and one-half years ago. The Committee should not be allowed to re-litigate the issue of whether or not this Court properly exercised its discretion in granting the adequate protection contained in the Final DIP Order, because any such attempt is either a collateral attack on the Final DIP Order or an end run around its own appeal process.

CONCLUSION

WHEREAS, for the foregoing reasons, the Prepetition Secured Creditors respectfully request that this Court (i) overrule the Committee's Objection, and (ii) grant such other and further relief as is just and proper.

DATED: March 6, 2020

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DATED: March 6, 2020

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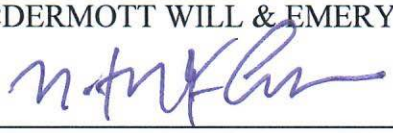

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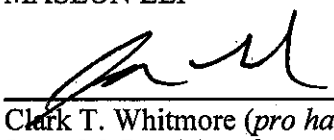

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PROOF OF SERVICE OF DOCUMENT

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 East, Suite 3100, Los Angeles, CA 90067

A true and correct copy of the foregoing document entitled (*specify*): **JOINT RESPONSE OF PREPETITION SECURED CREDITORS TO OFFICIAL COMMITTEE OF UNSECURED CREDITORS' OPPOSITION TO THIRD AMENDED SUPPLEMENTAL CASH COLLATERAL STIPULATION** 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*) March 6, 2020, 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*) _____, 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 F.R.Civ.P. 5 and/or controlling LBR, on (*date*) March 6, 2020, 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.

VIA FEDERAL EXPRESS: Honorable Ernest Robles U.S. Bankruptcy Court Roybal Federal Building 255 E. Temple Street, Suite 1560 Los Angeles, CA 90012	

☒ 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.

March 6, 2020	Diane Hashimoto	/s/ Diane Hashimoto
Date	*Printed Name*	*Signature*

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