

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

Wednesday, March 11, 2020

Hearing Room 1568

10:00 AM

2:18-20151 Verity Health System of California, Inc.

Chapter 11

#8.10 Hearing re [4184] and [4199] Official Committee Of Unsecured Creditors'
Objection To Third Amended Cash Collateral Stipulation

Docket 0

Matter Notes:

3/11/2020

The tentative ruling will be the order.

Party to lodge order: As set forth in the Tentative Ruling

POST PDF OF TENTATIVE OR AMENDED TENTATIVE RULING TO CIAO

Tentative Ruling:

3/10/2020

For the reasons set forth below, the Committee's Objection to the Third Amended Cash Collateral Order is **OVERRULED**.

Pleadings Filed and Reviewed:

- 1) 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 [Doc. No. 4184] (the "Third Amended Cash Collateral Stipulation")
- 2) Final Order Approving 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 [Doc. No. 4187] (the "Third Amended Supplemental Cash Collateral Order")
- 3) 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 [Doc. No. 4199] (the "Objection")



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- a) Declaration of James C. Behrens Regarding Notice and Service of Cash Collateral Objection and Scheduling Order [Doc. No. 4227]
- 4) Order Setting Hearing on Official Committee of Unsecured Creditors' Objection to Third Amended Cash Collateral Stipulation [Doc. No. 4200]
- 5) Joint Response of Prepetition Secured Creditors to Official Committee of Unsecured Creditors' Opposition to Third Amended Supplemental Cash Collateral Stipulation [Doc. No. 4225]
- 6) Debtors' Reply to 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 [Doc. No. 4226]
- 7) Official Committee of Unsecured Creditors' Omnibus Reply to Responses to the Committee's Cash Collateral Objection [Doc. No. 4229] (the "Reply")

I. Facts and Summary of Pleadings

On August 31, 2018 (the "Petition Date"), Verity Health System of California ("VHS") and certain of its subsidiaries (collectively, the "Debtors") filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. The Debtors' cases are being jointly administered.

A. Background

On October 4, 2018, the Court entered a *Final Order (I) Authorizing Postpetition Financing, (II) Authorizing Use of Cash Collateral, (III) Granting Liens and Providing Superpriority Administrative Expense Status, (IV) Granting Adequate Protection, (V) Modifying Automatic Stay, and (VI) Granting Related Relief* [Doc. No. 409] (the "Final DIP Order"). The Final DIP Order authorized the Debtors to borrow up to \$185 million (the "DIP Financing") from Ally Bank (the "DIP Lender") under a credit agreement (the "DIP Credit Agreement"), and authorized the Debtors to use the cash collateral of the Prepetition Secured Creditors.¹

The Final DIP Order waived the estates' (a) right to surcharge the Prepetition Secured Creditors' collateral under § 506(c) and (b) right to assert, under § 552(b), that the equities of the case warranted a determination that the Prepetition Secured Creditors' security interest does not extend to the post-petition proceeds of the Prepetition Secured Creditors' collateral. The Official Committee of Unsecured Creditors (the "Committee") appealed the waiver of the estates' §§ 506(c) and 552(b) rights to the District Court. On August 2, 2019, the District Court dismissed the appeal as moot under § 364(e). The Committee's appeal of the District Court's

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dismissal is pending before the Ninth Circuit and is being considered for oral argument in June 2020.

Under the DIP Credit Agreement, the DIP Financing expired and matured in accordance with its terms on September 7, 2019. On September 6, 2019, the Court approved an agreement among the Debtors and the Prepetition Secured Creditors, under which the Debtors were authorized to use the Prepetition Secured Creditors' cash collateral to repay the DIP Financing and to continue operations. *See* Doc. No. 3022. On December 30, 2019, the Court approved a stipulation between the Debtors and the Prepetition Secured Creditors authorizing the continued use of cash collateral through January 31, 2020. *See* Doc. No. 3883. On January 31, 2020, the Court approved a second stipulation providing for the continued use of cash collateral through February 29, 2020. *See* Doc. No. 4019. On February 28, 2020, the Court approved a third stipulation providing for the continued use of cash collateral through May 2, 2020. *See* Doc. Nos. 4184 (the "Third Amended Cash Collateral Stipulation" or "Stipulation") and 4187 (the "Third Amended Supplemental Cash Collateral Order" or "Order").

On March 2, 2020, the Official Committee of Unsecured Creditors (the "Committee") filed an objection to the Third Amended Supplemental Cash Collateral Order. *See* Doc. No. 4199 (the "Objection"). Because the Committee had not had the opportunity to object to the approval of the Third Amended Cash Collateral Stipulation, the Court set this hearing on the Committee's Objection.

B. Summary of the Committee's Objection

The Committee makes the following arguments in support of its Objection to the Third Amended Supplemental Cash Collateral Order:

There is no representation in the Stipulation or Order that the cash collateral budget (the "Budget") provides for the payment of all allowed administrative claims in full. The Committee is concerned that the Prepetition Secured Creditors have agreed to pay some, but not all, of the administrative claims that will accrue during the period covered by the Budget. Because the Debtors have waived the right to surcharge the Prepetition Secured Creditors' collateral, it is imperative that the Prepetition Secured Creditors now commit to pay all of the costs and claims incurred by the Debtors postpetition. The Prepetition Secured Creditors need the bankruptcy process to realize the most value from their collateral. If administrative claims are left unpaid, the Prepetition Secured Creditors will obtain this benefit without paying the freight for

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the process that yields that value.

It is not sufficient for the Debtors to wait until plan confirmation to pay all allowed administrative claims, because there is no assurance that sufficient funds will be available for the payment of administrative claims after the Debtors' assets have been liquidated.

C. Summary of the Prepetition Secured Creditors' Response to the Committee's Objection

The Prepetition Secured Creditors make the following arguments in response to the Committee's Objection:

Given the Debtors' substantial cash flow losses, the Debtors are not entitled to the use of cash collateral absent the consent of the Prepetition Secured Creditors. 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. The Prepetition Secured Creditors will withdraw their consent to the use of cash collateral if they are compelled to guaranty the payment of all administrative claims. Thus, sustaining the Committee's Objection would immediately halt the Debtors' ongoing efforts to sell their hospitals, resulting in an almost immediate cessation of hospital operations and requiring the hospitals to be liquidated at fire sale prices.

There is no merit to the Committee's contention that the Prepetition Secured Creditors have not "paid their freight" in exchange for the sale of their collateral. The Prepetition Secured Creditors have consented to the use of more than one-half billion dollars of their cash collateral, and continue to consent to the use of their cash collateral even as the prospects for recovery grow less certain.

D. Summary of the Debtors' Response to the Committee's Objection

The Debtors make the following arguments in response to the Committee's Objection:

The Committee's argument that the Stipulation must be disapproved because it does not expressly guaranty payment of all allowed administrative claims must fail, because it raises a hypothetical injury to a class of *postpetition* creditors that the Committee does not represent. The Committee lacks standing to raise this objection, because the Committee is not charged with the duty of advancing the interests of *post-petition*, administrative claimants.

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In addition, the Committee's argument is predicated on hypothetical injury, rather than injury in fact. As a result, the argument fails for lack of constitutional standing.

E. Summary of the Committee's Reply in Support of its Objection

The Committee makes the following arguments in its Reply in support of its Objection:

A debtor-in-possession has a duty to operate its business prudently and with a view to available resources. The failure of a debtor to do so by, for example, incurring administrative debt it could not pay would, at a minimum, be cause for conversion under § 1112(b). *See In re Pac. Airlines, Inc.*, 218 B.R. 590, 594 (Bankr. D. Colo. 1998) (finding that "cause" for conversion under section 1112 had been shown where "the Debtor [was] continuing to incur significant administrative expenses with no assurance of payment to administrative claimants").

While it is true that the choice of whether to permit the use of cash collateral belongs to the Prepetition Secured Creditors, the decision as to which administrative creditors can be paid does not rest with the Prepetition Secured Creditors—any more than it rests with the Debtors, who are not permitted to pay "some, but not all" administrative claims. *See In re Nunzio's Pizza, Inc.*, 202 B.R. 159 (Bankr. D. N.M. 1996) ("In fairness to the administrative claimants, the trustee should not pay some of the not yet allowed claimants, but omit others.")

II. Findings and Conclusions

Section 363(c)(2) requires court authorization for the use of cash collateral unless "each entity that has an interest in such cash collateral consents." In the Ninth Circuit, satisfaction of Section 363(c)(2)(A) requires the "affirmative express consent" of the secured creditor; "implied consent," resulting from the failure of the secured creditor to object to use of cash collateral, does not satisfy the requirements of the statute. *Freightliner Market Development Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368-69 (9th Cir. 1987). Absent affirmative express consent, the Debtors "may not use" cash collateral absent the Court's determination that the use is "in accordance with the provisions" of Section 363—that is, that the secured creditor's interest in the cash collateral is adequately protected. §§ 363(c)(2)(B) and (e).

The Prepetition Secured Creditors will not consent to the use of their cash collateral to fund these cases if the Prepetition Secured Creditors are required to guaranty the payment of all administrative claims. The Court cannot compel the

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Prepetition Secured Creditors to continue to finance the cases unless it finds that their interest in the cash collateral is adequately protected.

Here, the Court cannot find that the Prepetition Secured Creditors' cash collateral is adequately protected and therefore cannot compel the use of cash collateral absent the Prepetition Secured Creditors' consent. As the Court has stated on multiple prior occasions, the Debtor's cash flow situation is dire and the Debtors' assets are declining in value. The Debtors have been able to sustain operations only because the Prepetition Secured Creditors have allowed the Debtors to use proceeds from the Santa Clara County Sale (the "SCC Sale") to fund their remaining hospitals.

The abrupt termination of the Debtors' use of the Prepetition Secured Creditors' cash collateral would be detrimental to all constituencies in these cases—including the unsecured creditors represented by the Committee. Absent the continued use of cash collateral, the Debtors would not have sufficient time to adequately market their remaining hospitals. That would result in a marked reduction in the sales proceeds realized from the disposition of those assets.

The Court does not agree with the Committee's assertion that the Prepetition Secured Creditors have benefitted from the Debtors' disposition of their collateral without paying their share for the process that yields value. The Prepetition Secured Creditors have consented to the use of more than \$527 million in their cash collateral, as follows:

- 1) The Prepetition Secured Creditors consented to be primed by the DIP Lender. The DIP Financing was repaid using \$86 million of the Prepetition Secured Creditors' cash collateral.
- 2) The Prepetition Secured Creditors consented to the use of \$46 million in cash collateral that was held by the Debtors in the form of cash as of the Petition Date.
- 3) The Prepetition Secured Creditors consented to the use of \$219 million in cash collateral that was held by the Debtors in the form of net accounts receivable as of the Petition Date.
- 4) The Prepetition Secured Creditors consented to the use of \$176 million in cash collateral, received by the Debtors in the form of proceeds of the SCC Sale. Absent the use of these sales proceeds, the Debtors would not have had sufficient funds to keep their remaining hospitals open.

The Committee's assertion that the Debtors are required to obtain a cash collateral

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stipulation which provides for the payment of all administrative claims as they come due is not supported by the Bankruptcy Code. The Code's only requirement is that administrative claims be paid in full as of the effective date of a Plan, unless the administrative claimant agrees to different treatment. § 1129(a)(9). In any bankruptcy case, there is always some risk that there will not be sufficient cash available at the confirmation stage to pay all administrative claimants in full. The existence of such risk does not mean that the Debtors are neglecting their fiduciary duties or are failing to operate their businesses prudently.

Based upon the foregoing, the Committee's Objection to the Third Amended Cash Collateral Order is **OVERRULED**. The Court will prepare and enter an appropriate order.

No appearance is required if submitting on the court's tentative ruling. If you intend to submit on the tentative ruling, please contact Carlos Nevarez or Daniel Koontz, the Judge's Law Clerks, at 213-894-1522. **If you intend to contest the tentative ruling and appear, please first contact opposing counsel to inform them of your intention to do so.** Should an opposing party file a late opposition or appear at the hearing, the court will determine whether further hearing is required. If you wish to make a telephonic appearance, contact Court Call at 888-882-6878, no later than one hour before the hearing.

Party Information

Debtor(s):

Verity Health System of California,

Represented By

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