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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA, SACRAMENTO DIVISION

In re Highlands Community Charter and Technical Schools, Debtor and Debtor in Possession.[1]	Case No. 26-25868 Chapter 11 **DCN: SMR-5** Judge: Hon. [●] Date: [●], 2026 Time: [●] Place: [●]

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF DEBTOR'S EMERGENCY MOTION FOR ENTRY OF INTERIM AND FINAL ORDERS (I) AUTHORIZING THE DEBTOR TO USE CASH IN THE ORDINARY COURSE OF BUSINESS IN ACCORDANCE WITH APPROVED BUDGET; (II) AUTHORIZING THE STATE OF CALIFORNIA TO RECOVER PREPETITION OVERPAYMENTS FROM FUTURE APPORTIONMENTS; (III) FINDING THAT HOLDERS OF EQUIPMENT LIENS ARE ADEQUATELY PROTECTED; AND (IV) GRANTING RELATED RELIEF

[1] The last four digits of the Debtor's federal tax identification number is 0967. The mailing address for the Debtor is 1111 Howe Ave., Suite 505, Sacramento, CA 95825.

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Highlands Community Charter and Technical Schools ("HCCTS" or, the "Debtor"), a California Non-Profit Corporation organized under the laws of the State of California, and the above-captioned debtor and debtor-in-possession in this voluntary chapter 11 case (the "Chapter 11 Case") filed on the date hereof (the "Petition Date") under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"), hereby submits this Memorandum of Points and Authorities (the "Memorandum") in support of its motion (the "Motion") for entry of orders, substantially in the form attached to the Exhibit List as **Exhibit A** and **Exhibit B** (the "Interim Order" and the "Final Order" respectively) filed concurrently herewith, pursuant to §§ 105, 361, 362, 363, and 553 of the Bankruptcy Code, Rules 4001, 6003, and 6004 of the Federal Rules of Bankruptcy Procedures (the "Bankruptcy Rules"), and Rules 1001-1(f) and 9014-1(f) of the Local Rules of Practice ("LBR"):

(i) authorizing the Debtor to use its cash, including cash on hand as of the Petition Date and cash received after the Petition Date (collectively, the "Cash"), to fund its operations and the administration of this Chapter 11 Case in accordance with the 13-week budget attached to the Exhibit List as **Exhibit C** (as may be modified from time to time in accordance with the Interim Order and the Final Order, the "Approved Budget");

(ii) authorizing the State of California (the "State"), pursuant to the Final Order, to recover from the Debtor the amounts by which the State overfunded HCCS and CICA relative to their respective actual 2025-26 average daily attendance (collectively, the "Overpayments") from the Debtor's LCFF (as defined below) apportionments for the 2026-27 school year under the Charters (as defined below) (the "2026-27 Apportionments") in accordance with the Recovery Terms (as defined below), including by applying the 2026-27 Apportionments that have accrued prior to the Petition Date (the "Withheld Apportionments");

(iii) solely to the extent necessary, pursuant to the Final Order, (a) modifying the automatic stay under section 362(d)(1) to permit the State to apply the Withheld Apportionments to the Overpayments, and (b) authorizing the Debtor to permit

the State to apply 2026-27 Apportionments payable after the Petition Date to the Overpayments in accordance with the Recovery Terms;

(iv) authorizing the Debtor to pay its obligations arising after the Petition Date under the Equipment Leases (as defined below) as they come due, and finding that the Equipment Lessor (as defined below) is adequately protected until the Debtor assumes or rejects the applicable Equipment Lease;

(v) scheduling a final hearing on the Motion (the "Final Hearing"); and

(vi) granting related relief.

In support of the Motion, the Debtor refers to the *Declaration of Jonathan Raymond in Support of Chapter 11 Petition and First Day Motions* (the "First Day Declaration")[2] and the *Declaration of Jonathan Raymond in Support of Debtors' Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtor to Use Cash in the Ordinary Course of Business in Accordance with Approved Budget; (II) Authorizing the State of California to Recover Prepetition Overpayments from Future Apportionments; (III) Finding that Equipment Lessors Are Adequately Protected; and (IV) Granting Related Relief* (the "Raymond Declaration"), and the exhibits in support of the Motion (the "Exhibit List"), filed contemporaneously herewith, and such other evidence and testimony as may be presented at the hearing on the Motion (the "Hearing").

I. PRELIMINARY STATEMENT

By the Motion, the Debtor seeks authority to continue operating its Schools without interruption as it works toward a successful reorganization in this Chapter 11 Case. The Debtor has no secured or unsecured funded debt and no entity other than the Debtor holds an interest in the Cash. Nor do the State's rights with respect to the Overpayments extend to the Cash itself. Even so, because the Debtor's students, employees, vendors, the Authorizer, and the State all have a stake in the Schools' continued operation, the Debtor is voluntarily providing the Court and parties in interest the benefit of the Approved Budget and will report its actual performance against it. That transparency is designed to give stakeholders predictability, reduce uncertainty

[2] Capitalized terms used but not otherwise defined in this Memorandum have the meanings ascribed to them in the First Day Declaration.

during the transition into chapter 11, and allow the Debtor to move forward on stable footing, notwithstanding that such disclosure is not otherwise required for the Debtor's ordinary course use of the Cash.

The Cash reflected in the Approved Budget includes amounts the State contends were overfunded to the Schools relative to their actual 2025-26 attendance. Rather than leave recovery of the undisputed portion of those Overpayments to an ad hoc or contested process in the middle of the school year, the Debtor proposes a defined mechanism, set forth in the Recovery Terms described below, under which the State will recover the Overpayments from future apportionments in an orderly and predictable manner. The Debtor seeks approval of the Recovery Terms only at the Final Order stage, following the Final Hearing, and the Interim Order sought in the first instance addresses solely the Debtor's use of Cash in accordance with the Approved Budget. And while the Debtor believes its proposed use of the Cash in accordance with the Approved Budget is squarely within the ordinary course of its business and would not, standing alone, require Court approval, the unusual circumstances presented here—including the scale of the Overpayments, the State's role as the Debtor's primary funder, and the need to provide certainty to students, employees, and other stakeholders during the school year—warrant the Court's endorsement of the Debtor's approach at the outset of this Chapter 11 Case.

II. JURISDICTION AND VENUE

The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334 and General Orders 182 and 223 of the United States District Court for the Eastern District of California. The Debtor confirms its consent, pursuant to Bankruptcy Rule 7008, to the entry of a final order by the Court in connection with the Motion to the extent that it is later determined that the Court, absent consent of the parties, cannot enter final orders or judgments in connection herewith consistent with Article III of the United States Constitution.

This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2). Venue is proper pursuant to 28 U.S.C. §§ 1408 and 1409.

The bases for the relief requested herein are §§ 105, 361, 362, 363, and 553 of the Bankruptcy Code, Bankruptcy Rules 4001, 6003, and 6004, and LBRs 1001-1(f) and 9014-1(f).

III. FACTUAL BACKGROUND

A. General Background

The Debtor filed the Chapter 11 Case on the Petition Date. The Debtor is operating its business and managing its properties as a debtor in possession pursuant to §§ 1107(a) and 1108 of the Bankruptcy Code. No request for the appointment of a trustee or examiner has been made in this Chapter 11 Case, and no committees have been appointed or designated.

The Debtor is a California non-profit public benefit corporation that owns, manages, and operates two adult-serving charter schools in Sacramento County: Highlands Community Charter School ("HCCS") and California Innovative Career Academy ("CICA" and, together with HCCS, the "Schools"). The Twin Rivers Unified School District ("Twin Rivers") issued the current charters (the "Charters") that authorize HCCTS to operate both HCCS and CICA. Since opening in August 2014, HCCTS has served approximately 60,000 students. The Debtor is exempt from federal income taxation as an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986. A more detailed description of the Debtor, including its current and historical business operations and the events precipitating the Chapter 11 Case, is set forth in the First Day Declaration.

B. The Debtor's Capital Structure and Cash Position as of the Petition Date

As of the Petition Date, the Debtor holds approximately $93,571,466 in cash and cash equivalents across its three bank accounts (the "Bank Accounts"), which are described in detail in the *Debtor's Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtor to (A) Maintain Existing Bank Accounts, (B) Continue Use of Cash Management System, (C) Continue Use of Business Forms, and (D) Honor Certain Prepetition Obligations Related Thereto; (II) Waiving Requirements of LBR 2015-2; (III) Granting Limited Waiver of Section 345(b) Deposit Requirements; and (IV) Granting Related Relief* (the "Cash Management Motion") filed contemporaneously herewith.

Of that amount, approximately $51,787,028 (comprised of approximately $48,644,422 for HCCS and approximately $3,142,606 for CICA) is restricted cash and the remainder is unrestricted cash. The restricted cash consists of categorical and grant funds that the Debtor

receives subject to restrictions imposed by the applicable federal, state, and local grant programs, including funds designated for specific instructional, nutrition, and special education programs. The Debtor may use those funds only for the purposes designated by the applicable grantor, and it accounts for them separately from its unrestricted cash in accordance with the grant programs' requirements. Those restrictions are conditions of the grants, not interests of a third party in the Cash, and the Debtor will continue to use restricted cash only for its designated purposes and to account for it as the grant programs require. The Debtor's unrestricted cash, which is not subject to any such limitations, is the primary source of funding for the Debtor's general operating expenses under the Approved Budget, which is described further below.

The Debtor has no funded debt, has not issued any bonds or notes, and is not a party to any credit agreement, loan agreement, or line of credit. The Debtor's only secured debt consists of certain equipment leases described further below. The Debtor's most significant prepetition obligations are: (a) the unliquidated and disputed approximately $186 million Audit Liability described in the First Day Declaration, which arises from the Audit Report and remains subject to the pending Audit Appeal; (b) the Overpayments described below; (c) accrued prepetition wages, paid time off, and other employee-related obligations, as further described in the *Debtor's Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtor to (A) Pay Prepetition Wages, Salaries, and Other Compensation, (B) Continue Employee Benefits, and (C) Honor Certain Prepetition Obligations Related Thereto; and (II) Granting Related Relief* (the "Wages Motion") filed contemporaneously herewith; and (d) approximately $800,000 on account of trade debt and other amounts owing to vendors and service providers in the ordinary course of business. Aside from these obligations, the Debtor has no other material prepetition liabilities.

C. The Debtor's Revenue Streams

1. LCFF and Other Statutory Funding Sources

The Debtor's primary source of revenue is the Local Control Funding Formula ("LCFF"), codified principally at California Education Code §§ 42238.02 and 42238.03, which applies to school districts and charter schools on equivalent terms. Upon approval of a charter petition and

commencement of instruction, a charter school becomes a local educational agency ("LEA") entitled to State apportionments. Cal. Educ. Code § 47612. Because charter schools are creatures of statute, the right to LCFF funding arises by operation of law upon approval of the charter and commencement of instruction. *Wilson v. State Bd. of Educ.*, 75 Cal. App. 4th 1125, 1135–37 (1999). The Superintendent of Public Instruction (the "Superintendent") calculates each charter school's LCFF entitlement based on the school's certified average daily attendance ("ADA") and apportions funding in an amount equal to that calculation. Cal. Educ. Code § 42238.03. LCFF amounts are continuously appropriated under Cal. Educ. Code §§ 42238.03(a) and 14002, meaning payment does not depend on annual budget enactments and is not discretionary once ADA is reported and certified. Article XVI, section 8 of the California Constitution reinforces the mandatory character of the funding obligation by dedicating a guaranteed minimum share of General Fund revenues to K-12 education.

Two distinct revenue streams flow to the Debtor under this framework: (i) the LCFF apportionment itself, computed by the Superintendent and paid from the State School Fund; and (ii) a transfer of funding in lieu of property taxes by Twin Rivers, as the Debtor's authorizing LEA, under Cal. Educ. Code § 47635. Depending on whether the Debtor has made a direct funding election under Cal. Educ. Code § 47651, LCFF apportionments are paid either directly to the school by the county superintendent of schools or through Twin Rivers. The Debtor has made a direct funding election under Cal. Educ. Code § 47651(a)(1). For the 2026-27 school year, the Debtor's aggregate ADA is projected at approximately 1,207.2 (comprised of approximately 651.7 for HCCS and approximately 555.5 for CICA), yielding aggregate projected LCFF apportionments of approximately $21,772,607 (comprised of approximately $11,230,457 for HCCS and approximately $10,542,150 for CICA).

In addition to the LCFF, the Debtor receives other State funding allocated through various block grants and categorical programs, including funding tied to pupil attendance, instructional support, and arts and music education. The Debtor also receives federal funding passed through the California Department of Education, including funding to support adult education and school

improvement for local educational agencies. These federal and categorical funds are generally restricted to the specific purposes for which they are granted, as described above.

2. Statutory Process for Recovering Overpayments Under California Law

California law establishes two statutory pathways by which the State may withhold future LCFF apportionments from a charter school to recoup prior overpayments. The first pathway, under Cal. Educ. Code § 41341, addresses computational errors in the apportionment process itself. If the amount apportioned to a charter school differs from the amount to which it was entitled by at least the LCFF allocation for one unit of ADA, the Superintendent must withhold the excess (or add the deficiency) from the apportionment made in the first succeeding fiscal year. Cal. Educ. Code § 41341(a)(1). That one-year limitation does not apply, however, to amounts identified through the audit process described below. Cal. Educ. Code § 41341(a)(2).

The second, more comprehensive pathway proceeds through the annual audit process under Cal. Educ. Code §§ 41020 and 41344. Each charter school must undergo an annual audit of its funds, including an audit of pupil attendance procedures, conducted by a certified public accountant and filed with the Superintendent, the State Controller, and the charter school's chartering authority by January 31 following the audited fiscal year. Cal. Educ. Code § 41020. Upon receiving the audit report, the Superintendent must make any adjustments to future apportionments necessary to correct audit exceptions, and where a charter school must repay a significant exception, the Superintendent and the Director of Finance jointly establish a repayment plan. Cal. Educ. Code § 41344(a). Absent an approved multi-year plan, the State Controller withholds the entire disallowed amount from the charter school's next principal apportionment; but where immediate repayment would constitute a severe financial hardship, the Superintendent and the Director of Finance may instead approve equal annual payments over up to eight years. Cal. Educ. Code § 41344(a)(2). In addition to this direct monetary recoupment, the charter school's ADA for the audited fiscal year is reduced by the amount disallowed in the audit, which in turn temporarily reduces its future LCFF entitlement for the following fiscal year, though not beyond the value of the disallowed ADA plus applicable interest and penalties. Cal. Educ. Code § 41344(b).

D. The Overpayments and Withheld Apportionments

The Overpayments at issue in this Motion are separate and distinct from the Audit Liability described in Part II.B above. The Overpayments arise because charter schools that were in operation in the prior fiscal year are initially funded in the subsequent year based on the average daily attendance ("ADA") reported in that prior year. The Schools experienced a significant enrollment decline in the 2025-26 fiscal year, resulting in a corresponding decline in actual ADA. Because the Schools were initially funded at the prior year's higher ADA rate, the State overfunded the Schools relative to their actual 2025-26 ADA.

By letter dated August 17, 2026, the California Department of Education ("CDE") demanded payment of $30,820,947.00 from HCCS on account of the Overpayments attributable to HCCS. The State has separately claimed that CICA owes approximately $22,404,357.00 on account of the Overpayments attributable to CICA. The Debtor disputes the amount the State claims CICA owes. CICA is a nonclassroom-based charter school, and nonclassroom-based charter schools must obtain a funding determination from the State Board of Education ("SBE") to establish their funding rate. Cal. Educ. Code § 47612.5(d)(1). CICA has been unable to obtain that funding determination because the SBE requires a completed audit of CICA's 2023-24 fiscal year, and that audit has not yet been finalized. As a result, CICA has received no State funding determination for the 2025-26 fiscal year or for the current fiscal year to date, despite continuing to serve students. Because CICA has not received a funding determination for the 2025-26 school year, the State has asserted that the entire $22,404,357 amount is an overpayment. CICA believes that, if it had received a funding determination for the 2025-26 school year (and once it does), the actual overpayment amount will be approximately $12.2 million, though the ultimate amount is not yet known. Accordingly, while HCCTS does not dispute that, absent the Chapter 11 Case, HCCS would owe the State the full $30,820,947.00 reflected in the CDE's demand, HCCTS disputes the amount the State claims is owed on account of CICA's Overpayments.

The State has begun to recover the Overpayments by reducing the Debtor's LCFF apportionments for the current, 2026-27 school year (the "2026-27 Apportionments"). As of the Petition Date, the State has withheld, on account of the Overpayments, approximately $1,813,024

of 2026-27 Apportionments owed to HCCS and $1,729,611 of 2026-27 Apportionments owed to CICA, in each case that had accrued prior to the Petition Date (collectively, the "Withheld Apportionments"). In the ordinary course, the State would further be entitled to withhold the full amount of each subsequent 2026-27 Apportionment, up to the amount of the Overpayments, until the Overpayments are recouped in full.

E. The Proposed Recovery Terms

In order to effectuate the relief sought in this Motion, the Debtor seeks approval, pursuant to the Final Order, of the following terms governing the State's recovery of the Overpayments (the "Recovery Terms"):

(a) ***Application of Withheld Apportionments.*** Upon entry of the Final Order, the State may apply the Withheld Apportionments to the Overpayments.

(b) ***Recovery from Future Apportionments.*** Following entry of the Final Order, the State may withhold up to 100% of each 2026-27 Apportionment otherwise payable to HCCS or CICA, as applicable, and apply the amount withheld to the Overpayments attributable to that School, until the Overpayments attributable to that School, as agreed by the parties or determined by further order of the Court, are recovered in full.

(c) ***Order of Application.*** Amounts withheld from HCCS's 2026-27 Apportionments will be applied only to the Overpayments attributable to HCCS, and amounts withheld from CICA's 2026-27 Apportionments will be applied only to the Overpayments attributable to CICA. The State may not apply amounts otherwise payable to one School against the Overpayments attributable to the other School.

(d) ***Termination.*** The State's right to withhold and apply 2026-27 Apportionments under the Recovery Terms will terminate automatically, with respect to each School, upon the earliest of (a) recovery in full of the Overpayments attributable to that School, (b) the end of the 2026-27 school year, after which the State may seek such further relief as may be appropriate, or (c) revocation

of the Charter for that School, in which case termination will apply only with respect to the School whose Charter is revoked.

(e) ***Reporting.*** Within twenty-one (21) days after the end of each calendar month, the State will provide the Debtor with a statement showing, for each School, the amount of 2026-27 Apportionments withheld during that month, the amount applied to the Overpayments, and the remaining unrecovered balance of the Overpayments.

(f) ***No Other Interest in Cash.*** The Recovery Terms apply solely to the Debtor's 2026-27 Apportionments. They do not grant the State any lien on, security interest in, or other right to apply the Debtor's Cash or any other property of the estate.

(g) ***Reservation of Rights.*** Nothing in the Recovery Terms, the Motion, the Interim Order, or the Final Order shall constitute an admission by the Debtor as to the validity or amount of the Overpayments, or a waiver of the Debtor's right to contest the Overpayments attributable to either School, in whole or in part, by any available means, including on the basis that the amount owed will be reduced if the State Board of Education grants CICA's pending funding determination request. If the amount of the Overpayments attributable to either School is subsequently reduced by agreement of the parties or further order of the Court, the State will promptly remit to the Debtor any amounts withheld in excess of the corrected amount. Nothing in the Recovery Terms constitutes an admission by the State as to the characterization of its recovery as recoupment, setoff, or otherwise.

The Debtor has engaged in discussions with representatives of the State prior to the Petition Date regarding the Overpayments and the Withheld Apportionments generally. Those discussions are ongoing, but the Debtor and the State have not discussed the specific Recovery Terms proposed herein, which reflect the Debtor's own proposal for the Court's consideration.

The Debtor and its advisors intend to continue discussions with the State and will update the Court on their status at or before the Final Hearing.

F. The Approved Budget

The Approved Budget projects the Debtor's receipts and disbursements for the 13 weeks following the Petition Date. It includes payroll and benefits, facilities costs, payments under the Equipment Leases, instructional and operating expenses, and the costs of administering this Chapter 11 Case. The Approved Budget reflects the Debtor's plan to fund its operations during the Chapter 11 Case primarily with its Cash on hand, while the State recovers the Overpayments from the Debtor's 2026-27 Apportionments in accordance with the Recovery Terms. Under that plan, the Withheld Apportionments are applied first, and the State thereafter withholds up to 100% of each subsequent 2026-27 Apportionment and applies it to the outstanding Overpayments, as described above. The Debtor's Cash on hand, which does not depend on the 2026-27 Apportionments, is sufficient to fund operations throughout the Approved Budget period and the duration of the 2026-2027 school year.

The Debtor will report its actual results against the Approved Budget as described in monthly reports comparing the Debtor's actual receipts and disbursements to the Approved Budget, to be provided to the Office of the United States Trustee, the State, and any official committee appointed in this Chapter 11 Case. In addition, the State will provide periodic reporting pursuant to the Recovery Terms.

Without authority to use its Cash, the Debtor could not meet its payroll postpetition or satisfy other administrative expenses incurred in the ordinary course of business, and would be forced to close the Schools imminently, in the middle of the school year. That would displace approximately 2,000 students and approximately 167 employees, and it would jeopardize the Charters and the value of the Debtor's operations.

G. The Equipment Leases

The Debtor is party to certain leases of personal property with De Lage Landen Financial Services, Inc. and Canon Financial Services, Inc., each of which covers equipment used in the Schools' daily operations. Pursuant to the *Debtor's Emergency Motion for Entry of an Order*

Authorizing Rejection of Certain Unexpired Leases (the "Lease Rejection Motion") filed contemporaneously herewith, the Debtor is seeking to reject certain of its personal property leases with Canon Financial Services, Inc. The leases with De Lage Landen Financial Services, Inc. that the Debtor is not rejecting (collectively, the "Equipment Leases," and the lessor thereunder, the "Equipment Lessor") generally require regular monthly payments and, as of the Petition Date, the Debtor estimates that it owes approximately $10,141 in accrued and unpaid amounts under the Equipment Leases.

The Equipment Lessor holds liens on the equipment subject to the Equipment Leases, as evidenced by UCC financing statements filed with the California Secretary of State. The Equipment Lessor holds no interest in the Debtor's Cash or any property other than the equipment subject to the Equipment Leases. The Debtor has not yet determined whether to assume or reject any of the Equipment Leases. Payments under the Equipment Leases over the period covered by the Approved Budget are included in the Approved Budget. The equipment is insured and maintained in accordance with the terms of the Equipment Leases.

IV. BASIS FOR RELIEF

A. The Court Should Authorize the Debtor to Use Its Cash to Fund Ordinary Course Operations in Accordance with the Approved Budget.

A debtor in possession authorized to operate its business under section 1108 of the Bankruptcy Code may, unless the court orders otherwise, "use property of the estate in the ordinary course of business without notice or a hearing." 11 U.S.C. § 363(c)(1). Outside the ordinary course, a debtor in possession "after notice and a hearing, may use, sell, or lease . . . property of the estate." 11 U.S.C. § 363(b)(1). Section 363 "is designed to allow a trustee (or debtor-in-possession) the flexibility to engage in ordinary transactions without unnecessary creditor and bankruptcy court oversight." *In re Roth Am., Inc.*, 975 F.2d 949, 952 (3d Cir. 1992).

The term "ordinary course of business" has been construed "to embrace the reasonable expectations of interested parties of the nature of transactions that the debtor would likely enter in the course of its normal, daily business." *Med. Malpractice Ins. Ass'n v. Hirsch (In re Lavigne)*, 114 F.3d 379, 384 (2d Cir. 1997) (citation omitted); *In re Dant & Russell, Inc.*, 853 F.2d 700, 704-

05 (9th Cir. 1988) ("The touchstone of 'ordinariness' is . . . the interested parties' reasonable expectations of what transactions the debtor in possession is likely to enter in the course of its business.") (quoting *Armstrong World Indus., Inc. v. Phillips, Inc. (In re James A. Phillips, Inc.)*, 29 B.R. 391, 394 (Bankr. S.D.N.Y. 1983)). The Debtor's proposed use of its Cash falls squarely within the ordinary course of its business. The Approved Budget provides for payroll, benefits, facilities costs, equipment lease payments, instructional materials, and other operating expenses of the type the Debtor incurs in every school year.

The limitation on the use of "cash collateral" in section 363(c)(2) does not apply to the Cash. Cash collateral consists of cash and cash equivalents "in which the estate and an entity other than the estate have an interest." 11 U.S.C. § 363(a). No entity other than the estate holds an interest in the Cash. The Debtor has no secured or unsecured funded debt obligations, and no creditor holds a lien on or control agreement with respect to any of the Debtor's deposit accounts. The Equipment Lessor's interests are limited to the equipment subject to the Equipment Leases. The State's rights with respect to the Overpayments do not extend to the Cash. Recoupment "permits a determination of the 'just and proper liability on the main issue;'" it reduces the amount the State pays the Debtor and does not create an interest in the Debtor's property. *Reiter v. Cooper*, 507 U.S. 258, 265 n.2 (1993) (citation omitted); *see Oregon v. Harmon (In re Harmon)*, 188 B.R. 421, 425 (B.A.P. 9th Cir. 1995) (recoupment "is not a claim in bankruptcy"). Setoff, likewise, "allows entities that owe each other money to apply their mutual debts against each other." *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995). Any recoupment and/or setoff right the State may hold therefore runs against the State's own apportionment obligations, not against funds the Debtor holds at third-party banks. *See* 11 U.S.C. § 506(a)(1) (claim secured "to the extent of the amount subject to setoff"). Postpetition receipts are likewise free of any interest. *See Far E. Nat'l Bank v. U.S. Trustee (In re Premier Golf Props., L.P.)*, 477 B.R. 767, 771 (B.A.P. 9th Cir. 2012) ("As a general rule, postpetition revenue is not cash collateral.").

The Debtor's use of the Cash is therefore governed by sections 363(b) and (c)(1). To the extent any disbursement in the Approved Budget could be viewed as outside the ordinary course, it is a sound exercise of the Debtor's business judgment. Courts approve a debtor's use of estate

property under section 363(b) where the debtor articulates a sound business justification. *See Walter v. Sunwest Bank (In re Walter)*, 83 B.R. 14, 19-20 (B.A.P. 9th Cir. 1988) (quoting *In re Continental Airlines, Inc.*, 780 F.2d 1223, 1226 (5th Cir. 1986)); *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983). "Where the debtor articulates a reasonable basis for its business decisions (as distinct from a decision made arbitrarily or capriciously), courts will generally not entertain objections to the debtor's conduct." *Comm. of Asbestos-Related Litigants v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 60 B.R. 612, 616 (Bankr. S.D.N.Y. 1986).

The justification here is plain. The Cash is the Debtor's principal source of liquidity during the Chapter 11 Case. Without it, the Debtor could not meet its postpetition payroll obligations or satisfy other administrative expenses incurred in the ordinary course of business, meaning the Debtor would be forced to close the Schools imminently, displacing approximately 2,000 students and approximately 167 employees, and jeopardizing the Charters. Continued operation preserves the going-concern value of the Schools for all stakeholders.

Categorical funds included in the Cash are subject to restrictions on their use imposed by the applicable grant programs. Those restrictions are conditions of the grants and funding programs, not interests of a third party in the Cash. The Debtor will continue to spend restricted funds only for their permitted purposes and to account for them as the grant and funding programs require.

To provide transparency to its stakeholders, the Debtor will operate materially in accordance with the Approved Budget. It will provide monthly reports comparing actual receipts and disbursements to the Approved Budget to the Office of the United States Trustee (the "U.S. Trustee"), the State, and any official committee appointed in this Chapter 11 Case. Because no entity holds an interest in the Cash, the Proposed Orders do not grant liens, superpriority claims, or other protections typically required in connection with the use of cash collateral.

Finally, section 105(a) authorizes the Court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). An order authorizing the Debtor's use of its Cash in accordance with the Approved Budget will give the

Debtor's students, employees, vendors, the Authorizer, and the State confidence that the Schools will continue to operate without interruption.

B. The Court Should Authorize the State, Pursuant to the Final Order, to Recover the Prepetition Overpayments from Future Apportionments.

1. The Court Has Authority to Authorize the Recovery on the Recovery Terms.

The Debtor's rights to payment of its 2026-27 Apportionments are property of its estate. 11 U.S.C. § 541(a)(1). Permitting the State to apply those apportionments to the Overpayments on the Recovery Terms is a use of estate property that the Court may authorize under section 363(b). The Court may also enter any order "necessary or appropriate to carry out the provisions of this title" under section 105(a), and may modify the automatic stay, to the extent it applies, under section 362(d)(1).

Authorizing the recovery on the Recovery Terms is a sound exercise of the Debtor's business judgment. Permitting the State to withhold the full amount of each future apportionment, up to the amount of the Overpayments, allows the Debtor to resolve the Overpayments in the most direct and administrable way available, without diverting estate resources into a contested recoupment or setoff dispute with the State during the school year. Because the State is the Debtor's primary funder, preserving that relationship on clear, predetermined terms benefits the estate more than preserving a larger share of apportionments subject to an unresolved dispute with the State. And it defines the mechanics of the recovery, including reporting, so that disputes can be identified and resolved promptly. As shown below, the State is entitled to recover the Overpayments through the apportionment process in any event. The Recovery Terms therefore do not give the State anything it would not otherwise receive. They govern only the timing and mechanics of the recovery, to the estate's benefit.

2. The State's Recovery Is a Recoupment.

The Ninth Circuit defines recoupment as "the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim." *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996) (emphasis and citation omitted). Unlike setoff, recoupment is not subject to the

limitations in section 553, and "is not limited to pre-petition claims"—it "may be employed to recover across the petition date." *Sims v. U.S. Dep't of Health & Human Servs. (In re TLC Hosps., Inc.)*, 224 F.3d 1008, 1011 (9th Cir. 2000); *Newbery*, 95 F.3d at 1399. The Ninth Circuit has also described recoupment as "a non-statutory, equitable exception to the automatic stay." *Newbery*, 95 F.3d at 1403 (quoting *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1081 (3d Cir. 1992)); *see also Holford v. Powers (In re Holford)*, 896 F.2d 176, 179 (5th Cir. 1990).

Recoupment is limited to claims and rights that "arise from the same transaction or occurrence that gave rise to the liability sought to be enforced by the bankruptcy estate." *TLC Hosps.*, 224 F.3d at 1011. "The crucial factor" in that inquiry is the "logical relationship" between the two obligations, a concept that "is not to be applied so loosely that multiple occurrences in any continuous commercial relationship would constitute one transaction." *Id.* at 1012 (quoting *Newbery*, 95 F.3d at 1403). The question is whether the creditor's rights are sufficiently connected, legally and factually, to the debtor's countervailing claim that they fairly form part of the same transaction. *See Gardens Reg'l Hosp. & Med. Ctr. Liquidating Tr. v. California (In re Gardens Reg'l Hosp. & Med. Ctr., Inc.)*, 975 F.3d 926, 933-35 (9th Cir. 2020).

In *TLC Hospitals*, the Ninth Circuit applied that test to the Medicare reimbursement system, under which providers are paid on an estimated basis and the estimates are later audited and adjusted. The court held that, "under this specialized and continuous system of estimated payments and subsequent adjustments," the government's prepetition overpayments and its postpetition payment obligations "were parts of the same transaction for purposes of recoupment." 224 F.3d at 1012. The court further held that "[t]he fact that the overpayments and underpayments relate to different fiscal years does not destroy their logical relationship or indicate that they pertain to separate transactions." *Id.* at 1013. Other circuits applying the logical relationship test have reached the same result. *See United States v. Consumer Health Servs. of Am., Inc.*, 108 F.3d 390, 395 (D.C. Cir. 1997); *Holyoke Nursing Home, Inc. v. Health Care Fin. Admin. (In re Holyoke Nursing Home, Inc.)*, 372 F.3d 1, 4 (1st Cir. 2004).

In *Gardens Regional*, the Ninth Circuit applied the same principles to a California funding program. The State had deducted a hospital's unpaid Hospital Quality Assurance Fee assessments from two payment streams. The first was supplemental payments made from the same segregated fund into which the assessments were paid. The second was fee-for-service Medi-Cal payments. The court held that the deductions from the supplemental payments were recoupment, because the statutory program created a direct legal and factual connection between the payments into and out of the same fund. 975 F.3d at 937–39. The deductions from the fee-for-service payments were not recoupment. Those payments were earned under a separate, preexisting payment system, and a general statutory right to deduct amounts owed to the State could not by itself supply the necessary relationship. *Id.* at 939.

The State's recovery of the Overpayments falls on the recoupment side of that line. The Debtor's apportionments for the 2025-2026 school year in which each School was overfunded and its 2026-27 Apportionments are installments of the same statutory entitlement, calculated under the same formula, for the same local educational agency, under the same Charters, and reconciled through the same sequence of certifications. The Overpayments exist only because the LCFF system pays estimated amounts that are later corrected, and the mechanism for correcting them is an adjustment to subsequent apportionments within that same system. Cal. Educ. Code § 14005 expressly authorizes the State to adjust future apportionments to account for errors in prior-year ADA reporting, and Cal. Educ. Code § 41206.1 requires that annual appropriations reflect the adjustments in the Superintendent's final certification of apportionments. That statutory structure—like the Medicare statute's requirement that the Secretary make adjustments on account of prior overpayments—evinces the Legislature's intent that a charter school's stream of apportionments be treated as one continuous transaction, bearing the same direct legal and factual connection the Ninth Circuit found sufficient in *TLC Hospitals* and *Gardens Regional*. A California bankruptcy court has reached the same conclusion on closely analogous facts: in *In re Heffernan Memorial Hospital District*, 192 B.R. 228 (Bankr. S.D. Cal. 1996), the court allowed recoupment of Medicare overpayments from a California healthcare provider because the overpayment and reimbursement claims arose under the same, continuing provider agreement.

The Debtor's ongoing participation in the State's LCFF apportionment system under the same statutory framework is the equivalent of such a single, continuing agreement.

The equities point the same way. The Ninth Circuit applies recoupment where "it would . . . be inequitable for the debtor to enjoy the benefits of that transaction without meeting its obligations." *Newbery*, 95 F.3d at 1403 (quoting *Univ. Med. Ctr.*, 973 F.2d at 1081. The Debtor received the Overpayments as part of its apportionments and the Debtor will use those amounts to fund operations. In the ordinary course, the Debtor would continue to receive funding under the same system. It would be inequitable for the Debtor to accept 2026-27 Apportionments calculated under the LCFF while avoiding the LCFF's correction of the Schools' respective 2025-26 entitlements. The Ninth Circuit's recent decision in *Cooper v. Social Security Administration*, 131 F.4th 995 (9th Cir. 2025), reinforces this conclusion by contrast: the court there declined to apply recoupment to Social Security disability benefits, which beneficiaries receive involuntarily and without the kind of ongoing, voluntary participation in a reimbursement system that supports recoupment of Medicare overpayments. The Debtor, like a Medicare provider, has voluntarily and continuously participated in the LCFF apportionment system in exchange for advance, estimated payments subject to later adjustment, and it could choose to cease that participation by ceasing operation of the Schools. That voluntary, ongoing relationship is what distinguishes this case from one in which recoupment would not apply.

Because the State's recovery is recoupment, it is not subject to the automatic stay and would reduce the Debtor's 2026-27 Apportionments whether or not the Court authorized it. The Debtor asks the Court to authorize the recovery on the Recovery Terms so that the mechanics of that recovery are defined for the balance of the school year.

C. In the Alternative, the Court Should, Pursuant to the Final Order, Modify the Automatic Stay and Authorize the State to Set Off the Withheld Amounts in Accordance with the Recovery Terms.

To the extent any portion of the State's recovery is characterized as setoff rather than recoupment, the Court should, pursuant to the Final Order, (a) modify the automatic stay to permit

the State to apply the Withheld Apportionments, and (b) authorize the Debtor to permit the State to apply 2026-27 Apportionments payable after the Petition Date on the Recovery Terms.

Section 362(a)(7) stays "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." 11 U.S.C. § 362(a)(7). Section 553(a) preserves a creditor's right "to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case," subject to limitations not applicable here. 11 U.S.C. § 553(a). Setoff avoids "the absurdity of making A pay B when B owes A." *Strumpf*, 516 U.S. at 18 (quoting *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913)).

Each element of setoff under section 553(a) is present with respect to the Withheld Apportionments. The State holds a prepetition claim on account of the Overpayments, and the Withheld Apportionments are debts the State owed to the Debtor before the Petition Date. The claim and the debt are mutual, as both run between the State of California and the Debtor in the same capacity, and none of the exceptions in section 553(a)(1) through (3) applies. "Courts have generally concluded that the existence of mutual obligations subject to set-off constitutes sufficient 'cause' to meet the creditor's initial evidentiary burden in seeking relief from the automatic stay." *In re Nuclear Imaging Sys., Inc.*, 260 B.R. 724, 730 (Bankr. E.D. Pa. 2000) (citations omitted); *see also In re Ealy*, 392 B.R. 408, 414 (Bankr. E.D. Ark. 2008). Modifying the stay here also removes no value from the estate. The State's claim is secured to the extent of the amount subject to setoff under § 506(a)(1), so applying the Withheld Apportionments only accelerates a recovery to which the State is already entitled. To the extent the State's recovery from 2026-27 Apportionments payable after the Petition Date is not recoupment, the Debtor requests authority under sections 363(b) and 105(a) to permit that recovery on the Recovery Terms. Doing so is a sound exercise of the Debtor's business judgment.

As set forth above, the State's recovery constitutes recoupment under *TLC Hospitals* and *Gardens Regional*. Litigating the characterization of the recovery would be complex, would require expert testimony regarding LCFF mechanics, would consume estate resources during the

school year, and would be conducted while the State continues to control the Debtor's funding. And the Recovery Terms pace the State's recovery and make the Debtor's funding predictable, which allows the Debtor to continue operating the Schools and preserve the Charters for the benefit of all creditors. The State is the Debtor's primary funder, and the Debtor cannot operate the Schools without a continuing funding relationship with it. Authorizing the recovery on defined terms preserves that relationship while limiting the rate at which the State may recover. The alternative, a dispute with the State in the middle of the school year, would put at risk the very operations that give the estate its value.

D. Holders of Equipment Liens Are Adequately Protected.

On request of an entity with an interest in property the debtor uses, the court "shall prohibit or condition such use . . . as is necessary to provide adequate protection of such interest." 11 U.S.C. § 363(e). Section 363(e) applies to property subject to an unexpired lease of personal property. *Id.* The Debtor bears the burden of proof on adequate protection. 11 U.S.C. § 363(p)(1).

The Bankruptcy Code does not define adequate protection. *Pistole v. Mellor (In re Mellor)*, 734 F.2d 1396, 1400 (9th Cir. 1984). Section 361 provides non-exclusive examples, the first of which is "a cash payment or periodic cash payments" to the extent the debtor's use of property results in a decrease in the value of the entity's interest in that property. 11 U.S.C. § 361(1). The purpose of adequate protection is to "protect a secured creditor against a decrease in the value of its collateral due to the debtor's use, sale or lease of that collateral during the stay." *In re Timbers of Inwood Forest Assocs., Ltd.*, 793 F.2d 1380, 1389 (5th Cir. 1986), *aff'd sub nom. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988). What constitutes adequate protection is determined case by case. *See Martin v. United States (In re Martin)*, 761 F.2d 472, 474 (8th Cir. 1985).

The Equipment Lessor is adequately protected because the Debtor will pay its obligations under each Equipment Lease arising on and after the Petition Date as they come due, pending the Debtor's decision to assume or reject that lease. This goes beyond what section 365(d)(5) requires. Those periodic payments compensate the Equipment Lessor for the Debtor's use of its equipment during the Chapter 11 Case. The payments are included in the Approved Budget, and

the Debtor's Cash on hand is more than sufficient to fund them throughout the Approved Budget period. The Debtor's commitment to make the payments, not the Cash itself, is the protection, and the Approved Budget shows that the commitment will be kept. The Debtor will also continue to insure and maintain the equipment in accordance with the terms of the Equipment Leases.

The Debtor's payment of postpetition obligations under the Equipment Leases is also within the ordinary course of its business and is authorized under section 363(c)(1). The Debtor requests express authority to make those payments so that the Equipment Lessor has assurance of payment pending assumption or rejection.

The Debtor therefore requests a finding that the Equipment Lessor is adequately protected under sections 361 and 363(e) until the Debtor assumes or rejects the applicable Equipment Lease. The finding would be without prejudice to (a) the Debtor's right to assume or reject any Equipment Lease, or to contend that any Equipment Lease is a financing rather than a true lease; (b) any party's rights with respect to cure amounts or prepetition claims; and (c) the Equipment Lessor's right to seek additional adequate protection upon a showing of changed circumstances.

V. PROCESSING OF CHECKS AND ELECTRONIC FUND TRANSFERS

The Debtor has sufficient funds to pay the amounts described in the Motion in the ordinary course of business through cash on hand. Moreover, under the Debtor's existing cash management system, the Debtor can readily identify checks or wire transfer requests relating to an authorized payment. As such, the Debtor believes there is minimal risk that unauthorized checks or wire transfer requests will be inadvertently honored. The Debtor therefore respectfully requests that the Court authorize all applicable financial institutions, upon the Debtor's request, to receive, process, honor, and pay any and all checks or wire transfer requests in respect of the relief sought in the Motion.

VI. EMERGENCY CONSIDERATION

Bankruptcy Rule 6003 provides that, to the extent relief is necessary to avoid immediate and irreparable harm, the Court may issue an order within the first 21 days of a chapter 11 case granting "a motion to use, sell, lease, or otherwise incur an obligation regarding property of the

estate, including a motion to pay all or part of a claim that arose before the filing of the petition." Fed. R. Bankr. P. 6003(b).

For the reasons discussed herein and in the Motion and First Day Declaration, the Debtor respectfully requests that the Court enter an interim order in the form set forth on **Exhibit A** to the Exhibit List filed concurrently herewith: (a) authorizing the Debtor to use Cash in the ordinary course of business in accordance with the Approved Budget; (b) finding that the Equipment Lessor is adequately protected; (c) scheduling the Final Hearing; and (d) granting related relief, and, at the Final Hearing, that the Court enter the Final Order authorizing the State to recover the Overpayments from future LCFF apportionments in accordance with the Recovery Terms. The relief requested in the Motion is integral to the Debtor's ability to transition its operations into this Chapter 11 Case. Failure to obtain such authorization and other relief within the first 21 days of this Chapter 11 Case would severely disrupt the Debtor's operations at this critical juncture. The requested relief is necessary to enable the Debtor to operate its business in the ordinary course, continue to deliver quality educational services to its students without interruption, and preserve and maximize the value of the estate for the benefit of all stakeholders. Accordingly, the Debtor submits that it has satisfied the "immediate and irreparable harm" standard of Bankruptcy Rule 6003 and respectfully requests that the Court approve the relief sought in the Motion on an emergency basis.

VII. RESERVATION OF RIGHTS

Nothing herein shall constitute a waiver of any claims, rights, objections, or remedies available to the Debtor against any party. The Debtor expressly reserves the right to seek modification of any relief granted hereunder to the extent necessary to facilitate this Chapter 11 Case and the Debtor's ongoing operations, or as otherwise required to comply with any order entered by the Court in this Chapter 11 Case. Furthermore, nothing herein, nor any action taken in furtherance of the relief requested, shall be deemed or construed as: (i) an admission regarding the validity of any claim asserted against the Debtor, (ii) a waiver of the rights of the Debtor or any appropriate party in interest to contest any such claim, or (iii) an approval, adoption, or assumption of any agreement, contract, program, policy, or lease pursuant to § 365, nor shall

anything herein otherwise limit or affect the Debtor's rights under § 365 to assume or reject any executory contract with any party. Similarly, in the event the Court grants the relief requested herein, any payment made in accordance with the Court's order shall not be deemed, and should not be interpreted, as an admission of the validity of any claim or as a waiver of the Debtor's right to challenge such claim at a later time. Finally, no provision of the relief requested herein shall be construed to require or obligate the Debtor to accept any services from any party.

VIII. WAIVER OF BANKRUPTCY RULE 6004(A) AND 6004(H)

The Debtor requests a waiver of any applicable notice requirements under Bankruptcy Rule 6004(a) and any stay of the order granting the relief requested herein under Bankruptcy Rule 6004(h). As set forth above and in the First Day Declaration, the relief requested herein is necessary to avoid immediate and irreparable harm to the Debtor's ongoing operations and value-maximizing process. Accordingly, ample cause exists to justify waiver of the notice requirements under Bankruptcy Rule 6004(a) and the 14-day stay imposed by Bankruptcy Rule 6004(h), to the extent such requirements and stay are applicable.

IX. NOTICE

The Debtor will provide notice of the Motion and this Memorandum via first class mail, facsimile or email (where available) to: (a) the Office of the U.S. Trustee; (b) the holders of the twenty (20) largest unsecured claims against the Debtor filed in accordance with Bankruptcy Rule 1007(d); (c) the State of California through the Attorney General for the State of California; (d) the United States of America through the United States Attorney for the Eastern District of California; (e) Twin Rivers; (f) the Equipment Lessor; (g) East West Bank; (h) the Internal Revenue Service; (i) the United States Department of Education; and (j) parties that file with the Court and serve upon the Debtor requests for notice of all matters in accordance with Bankruptcy Rule 2002(i) (collectively, the "Notice Parties"). If the Court grants the relief requested by the Motion, the Debtor shall provide notice of the entry of the order granting such relief upon each of the foregoing parties and any other parties in interest as the Court directs. The Debtor submits that such notice is sufficient and that no other or further notice be given. No prior request for the relief sought herein has been made by the Debtor to any other court.

X. CONCLUSION

For the reasons set forth herein, the Debtor respectfully requests entry of an order: (i) authorizing the Debtor to use Cash in the ordinary course of business in accordance with the Approved Budget; (ii) pursuant to the Final Order, authorizing the State to recover the Overpayments from future LCFF apportionments in accordance with the Recovery Terms; (iii) finding that the Equipment Lessor is adequately protected; (iv) scheduling the Final Hearing; and (v) granting related relief.

Dated: October 4, 2026

SHEPPARD, MULLIN, RICHTER & HAMPTON LLP

By */s/ Ori Katz*
ORI KATZ
Proposed Counsel for Highlands Community Charter and Technical Schools