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**UNITED STATES DISTRICT COURT**
**CENTRAL DISTRICT OF CALIFORNIA**
**LOS ANGELES DIVISION**

| | |
|---|---|
| In re:<br><br>VERITY HEALTH SYSTEM OF CALIFORNIA, INC., *et al.*,<br><br>Debtors and Debtors In Possession. | DISTRICT COURT CASE NUMBER:<br>2:18-cv-10675-RGK<br><br>BANKRUPTCY COURT CASE NUMBER:<br>2:18−bk−20151−ER |
| OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF VERITY HEALTH SYSTEMS OF CALIFORNIA, INC., *et al.*<br><br>APPELLANT(S)<br><br>v.<br><br>VERITY HEALTH SYSTEM OF CALIFORNIA, INC., *et al.*<br><br>APPELLEE(S). | ADVERSARY CASE NUMBER:<br>N/A<br><br>**APPELLANT OFFICIAL COMMITTEE OF UNSECURED CREDITORS' APPELLANT'S BRIEF** |

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## CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 8012 of the Federal Rules of Bankruptcy Procedure, the Appellant, the Official Committee of Unsecured Creditors of Verity Health System of California, Inc. *et al.* (the "Committee"), discloses that it is a statutory body appointed by the Office of the United States Trustee, a division of the U.S. Department of Justice. Therefore, there is no parent corporation or any publicly held corporation that owns 10% or more of the Committee.

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## I. INTRODUCTION

The Official Committee of Unsecured Creditors of Verity Health System of California, Inc., *et al*. (the "Committee" or the "Appellant") appointed in the chapter 11 cases (the "Chapter 11 Cases") of the above-captioned debtors and debtors-in-possession (the "Debtors") is the statutory representative of, and fiduciary to, the unsecured creditors of the Debtors. These unsecured creditors include nurses, doctors, lab technicians, former employees, vendors, suppliers, the Pension Benefit Guaranty Corp., and tort claimants. The Debtors filed for bankruptcy for the purpose of selling the Hospitals (as defined below) and other health care facilities they own. The Debtors had been losing money for years and could not continue to sustain the operating losses. The Debtors' corporate and capital structure is complex, but there are essentially two classes of creditors: secured creditors and unsecured creditors.

This appeal (the "DIP Appeal") involves an order (the "Final DIP Order") of the court below (the "Bankruptcy Court") requiring the waiver of certain statutory rights made available under title 11 of the United States Code (the "Bankruptcy Code") to protect unsecured creditors against secured creditors. The Bankruptcy Court ordered the waiver of these rights because the Debtors' prepetition secured creditors (the "Prepetition Secured Creditors") conditioned their consent to new financing (the "DIP Facility") from a post-bankruptcy lender

(the "DIP Lender"), which financing was needed to operate the Hospitals while they were being sold during the Chapter 11 Cases, on the granting of such waivers. The Bankruptcy Court could have denied the requested waivers because it had found that the Prepetition Secured Creditors were oversecured (by virtue of an "equity cushion" in excess of 25%) and, consequently, were not required to consent to the financing, but it declined to do so.

Moreover, the Prepetition Secured Creditors—who were offered the opportunity to provide the requisite financing themselves but declined to do so—also required the Bankruptcy Court to grant them a security interest in assets that were not part of their collateral. So, the cumulative effect of the provisions of the Final DIP Order at issue here was to subordinate any potential recovery of the Debtors' unsecured creditors to the payment in full of the Prepetition Secured Creditors, even though such secured creditors' liens did not otherwise encumber all of the Debtors' assets. In other words, the so-called "price" demanded by the Prepetition Secured Creditors for keeping the Hospitals open until the Hospitals could be sold—a clear benefit to the secured creditors—was that the Chapter 11 Cases be run first and foremost for their economic benefit, notwithstanding any provisions of the Bankruptcy Code that might provide for unsecured creditors to share in the proceeds from the sales. This is more than slightly ironic given that it

is the unsecured creditors that are providing the patient care, supplies and services necessary to operate the Hospitals.

This was especially troubling because, as of the Petition Date (as defined below), there appeared to have been substantial unencumbered assets and value in the Debtors' estates that would, if not for the need to fund a sale process now being run primarily for the benefit of the Prepetition Secured Creditors, have been available to pay the holders of unsecured claims. For example, the Debtors represented to the Bankruptcy Court that there was no single secured creditor with liens on all of the Debtors' assets. (App.[1] Tab 3 (Declaration of Anita Chou (the "Chou Declaration") at ¶ 8.) Nor, according to the Debtors, did any secured creditor have perfected liens on the cash in the Debtors' operating account, which, according to the Debtors' schedules, contained more than $40 million. (*Id.*) Nonetheless, all such unencumbered assets and value were pledged to the Prepetition Secured Creditors, purportedly to protect them from the diminution in the value of their claims to be caused by the very ongoing operations that the Prepetition Secured Creditors needed in order to preserve the going concern value of their collateral until it could be sold, *i.e.*, the unsecured creditors were paying for the Prepetition Secured Creditors' opportunity to be paid in full while losing

[1] Citations to "App." refer to the Appendix in Support of Official Committee of Unsecured Creditors' Appellant's Brief, which is filed concurrently herewith

critical protections afforded to them by the Bankruptcy Code. (App. Tab 34 (Final DIP Order) at ¶ 5(a).)

The specific provisions of the Bankruptcy Code that the Bankruptcy Court ordered waived are section 506(c) (the "Section 506(c) Waiver") and section 552(b) (the "Section 552(b) Waiver"). The waivers were demanded by the Prepetition Secured Creditors under the guise of "adequate protection," a bankruptcy principle that requires a secured creditor to be protected from diminution in value of its collateral during the bankruptcy case. (App. Tab 33 (Final DIP Order) at ¶ 5(f).) Section 506(c) permits a debtor's estate to recover from, or "surcharge" a secured creditor's collateral, for the costs of preserving or selling that collateral for the secured creditor's benefit (the "Section 506(c) Surcharge Right"). Said another way, the statute requires the costs associated with preserving and selling collateral to be deducted from the recovery of those secured creditors who are benefitting the most from the sale rather than being passed along to unsecured creditors who are lower in priority of recovery under the "absolute priority" rule set forth in the Bankruptcy Code

The Section 552(b) Waiver, which reflects a blanket waiver of the estates' opt-out rights under section 552(b) of the Bankruptcy Code, is equally detrimental to the rights of unsecured creditors. (App. Tab 34 (Final DIP Order) at ¶ 5(f).) The "equities of the case exception" contained in section 552(b) of the

Bankruptcy Code (the "Section 552(b) Equities of the Case Exception"), if it had not been waived, would have allowed unsecured creditors to argue for the exclusion of post-petition proceeds of the Debtors' assets (or the value of labor with respect to such assets) from the Prepetition Secured Creditors' collateral package—a critical entitlement where, as here, it is far from clear that there will be enough value after the claims of the DIP Lender (as defined below) and the Prepetition Secured Creditors are satisfied to fund a distribution to the Debtors' unsecured creditors.

As a factual matter, there was no evidence presented to the Bankruptcy Court, nor could the Court possibly have determined during the first two weeks of the Chapter 11 Cases, that there would be no basis, by the time the sales of the Hospitals had concluded, to grant relief under section 506(c) or section 552(b). Thus, any finding of fact that prospectively waived the Section 506(c) Surcharge Right or the Section 552(b) Equities of the Case Exception could only have been premature.

Instead, the rights of all parties to argue that the Section 552(b) Equities of the Case Exception applied, as well as that exercise of the Section 506(c) Surcharge Right was warranted, should have been preserved. These waivers of unsecured creditor rights were disproportionate and unnecessary to properly protect the collateral of the Prepetition Secured Creditors, and, in

contravention of fundamental adequate protection principles, plainly permitted such creditors to better, and not merely maintain, their priority of recovery.

## II. JURISDICTIONAL STATEMENT

This Court has jurisdiction over the above-captioned matter under 28 U.S.C. § 158(a)(1), insofar as the Final DIP Order is a "final order" of the Bankruptcy Court subject to appeal as of right.

## III. STATEMENT OF ISSUES ON APPEAL

1. Whether the Bankruptcy Court erred in granting the Prepetition Secured Creditors an adequate protection package that included the Section 506(c) Waiver and the Section 552(b) Waiver, insofar as such adequate protection package was not "narrowly tailored" to protect the Prepetition Secured Creditors' existing rights where (i) the Court found that the claims of the Prepetition Secured Creditors were significantly oversecured; (ii) the Prepetition Secured Creditors were granted replacement liens and superpriority claims, such that the Debtors did not retain any unencumbered assets; (iii) but for the replacement liens, the Debtors had a substantial amount of unencumbered assets available for the benefit of unsecured creditors; and (iv) the Debtors' unsecured creditors have consequently been compelled to fund the costs of the liquidation of the Prepetition Secured Creditors' collateral.

2. Whether the Bankruptcy Court erred in granting the Prepetition Secured Creditors a waiver of the Debtors' rights under section 506(c) of the Bankruptcy Code (App. Tab 34 (Final DIP Order) at ¶ 5(f)) to surcharge collateral to satisfy the costs of preserving or selling the Prepetition Secured Creditors' collateral (the "Section 506(c) Surcharge Right") where (i) the Section 506(c) Surcharge Right was intended by Congress for the benefit of unsecured creditors and could only be waived for the benefit of secured creditors under limited circumstances; and (ii) none of these limited circumstances were present in the Chapter 11 Cases because (a) the Court found that the claims of the Prepetition Secured Creditors were significantly oversecured; (b) the Prepetition Secured Creditors were granted expansive replacement liens and superpriority claims, with the result that the Debtors relinquished to the Prepetition Secured Creditors all of their unencumbered assets; (c) but for the replacement liens, the Debtors would have had a substantial amount of unencumbered assets available for the benefit of unsecured creditors; and (d) without recourse to the Section 506(c) Surcharge Right, the Debtors' unsecured creditors would consequently be compelled to fund the costs of the liquidation of the Prepetition Secured Creditors' collateral.

3. Whether the Bankruptcy Court erred in granting the Prepetition Secured Creditors a waiver of the Debtors' rights under section 552(b) of the Bankruptcy Code (App. Tab 34 (Final DIP Order) at ¶ 5(f)) to contend that the

equities of the case justified the exclusion of post-petition proceeds from the Prepetition Secured Creditors' collateral where such Section 552(b) Equities of the Case Exception (i) was intended by Congress for the benefit of unsecured creditors; (ii) could not be waived prospectively without the requisite finding as to contemporaneous equitable need; (iii) could only be waived for the benefit of secured creditor under limited circumstances; and (iv) the requisite circumstances could not exist where (a) the Court found that the claims of the Prepetition Secured Creditors were significantly oversecured; (b) the Prepetition Secured Creditors were granted overly broad replacement liens and superpriority claims, with the result that the Debtors relinquished all of their (prepetition or postpetition) unencumbered assets to the Prepetition Secured Creditors; (c) but for the replacement liens, the Debtors had a substantial amount of unencumbered assets for the benefit of unsecured creditors; and (d) as a result of the foregoing, otherwise unencumbered assets were used by the Debtors to facilitate the recoveries of the Prepetition Secured Creditors.

## IV. STANDARD OF REVIEW

This appeal presents a mixed question of law and fact in that the facts are established, the rule of law is undisputed, and the issue is whether the legal rule has been applied properly to the facts. *Pullman-Standard v. Swint*, 456 U.S. 273, 289 n.19 (1982); *United States. v. McConney*, 728 F.2d 1195, 1200 (9th Cir. 1984)

(*en banc*) (same); *People's Capital & Leasing Corp. v Big3D, Inc.* (*In re Big3D, Inc.)*, 438 B.R. 214, 219-20 (B.A.P 9th Cir. 2010) (in reviewing adequate protection determination, appellate court must first "determine *de novo* whether the [bankruptcy] court identified the correct legal rule to apply to the relief requested [and] [i]f the bankruptcy court identified the correct legal rule, we then determine whether its application of the correct legal standard [to the facts] was (1) illogical, (2) implausible, or (3) without support in inferences that may be drawn from the facts in the record" (internal quotation marks omitted).) Because the facts are not in dispute, but rather the appeal only challenges whether the Bankruptcy Court correctly interpreted sections 361, 506(c) and 552(b) of the Bankruptcy Code and whether the Bankruptcy Court properly applied the law as to whether and when waivers of the Section 506(c) Surcharge Right and the Section 552(b) Equities of the Case Exception could be granted as adequate protection to the facts in the Chapter 11 Cases, this Court's review is essentially *de novo*. *McConney*, 728 F.2d at 1202-04; *accord Boone v. United States*, 944 F.2d 1489, 1492 (9th Cir. 1991); *In re Lee*, 179 B.R. 149, 155 (B.A.P. 9th Cir. 1995), *aff'd* 108 F.3d 239 (9th Cir. 1997).

## V. STATEMENT OF THE CASE

On August 31, 2018 (the "Petition Date"), Verity Health Systems of California ("VHS") and the remainder of the Debtors filed voluntary petitions for

relief under chapter 11 of the Bankruptcy Code. (App. Tab 4 (First Day Declaration) at ¶ 6.)

On September 6, 2018, the Court entered an Order (the "Interim DIP Order") authorizing the Debtors to borrow, on an interim basis, $30 million under a Debtor In Possession Revolving Credit Agreement with Ally Bank, as the DIP Lender. (App. Tab 9 (Interim DIP Order) at ¶¶ 1, 2(b); App. Tab 10 (Interim DIP Ruling) at 11; App. Tab 3 (Chou Decl.) at ¶ 28; App. Tab 16 (9/5/2018 Transcript) at 25, 39.)

On October 4, 2019, after a further hearing, the Bankruptcy Court entered the Final DIP Order, which authorized the Debtors to borrow the up to additional $155 million available under the DIP Facility from the DIP Lender on a final basis and, at the same time, granted, on a final basis, the Prepetition Secured Creditors the adequate protection package, including the Section 506(c) and Section 552(b) Waivers, that is at issue in this DIP Appeal. (Tab 29 (Final DIP Ruling) at 8, 9-10, 11; App. Tab 34 (Final DIP Order) at ¶¶ 1, 2(b), 5(f); App. Tab 35 (10/3/2018 Transcript) at 25-26.)

### A. Debtors' Business, Operations, and Flawed Business Model

Debtor VHS, a California nonprofit public benefit corporation, is the sole corporate member of the following five (5) Debtor nonprofit public benefit corporations that operate acute care hospitals: (i) O'Connor Hospital, (ii) Saint

Louise Regional Hospital, (iii) St. Francis Medical Center, (iv) St. Vincent Medical Center, and (v) Seton Medical Center/Seton Medical Center Coastside (collectively, the "Hospitals"). (App. Tab 4 (First Day Declaration) at ¶ 11.)

VHS, the Hospitals, and their affiliated entities (collectively, the "Verity Health System") operate a nonprofit health care system in the State of California, with approximately 1,680 in-patient beds, six active emergency rooms, a trauma center, and various medical specialties. (*Id.* at ¶ 12.) In 2017, the Hospitals provided medical services to over 50,000 inpatients and approximately 480,000 outpatients. (*Id.)*

Debtor Verity Medical Foundation ("VMF"), incorporated in 2011, is a medical foundation that contracts with physicians and other healthcare professionals to provide patient care throughout California. (*Id.* at ¶ 14.) VMF offers medical, surgical, and related healthcare services at community-based, multi-specialty clinics located in areas served by the Debtor Hospitals. (*Id*.)

Verity Holdings LLC ("Holdings"), a direct subsidiary of its sole member VHS, was created in 2016 to hold and finance Verity's interests in six (6) medical office buildings whose tenants are primarily physicians, medical groups, healthcare providers, and certain of the Hospitals. (*Id.* at ¶ 15.) Holdings' real estate portfolio includes over 30 properties. (*Id.*)

As of the Petition Date, the Debtors' facilities had approximately 850 patients, and were at approximately 50% occupancy. (*Id.* at ¶ 17.) As of the same date, the Debtors had approximately 7,385 employees, of whom 4,733 are full-time employees. (*Id.* at ¶ 18.) Approximately four percent (4%) of these employees are represented by collective bargaining units. (*Id.*)

The Hospitals and VMF were originally owned and operated by the Daughters of Charity of St. Vincent de Paul, Province of the West (the "Daughters of Charity"), to support the mission of the Catholic Church through a commitment to the sick and poor. (*Id.* at ¶ 82.) In March 1995, the Daughters of Charity merged with Catholic Healthcare West and, in June 2001, the Daughters of Charity Health System ("DCHS") was formed. (*Id.* at ¶ 83.) Between 1995 and 2018, the Daughters of Charity and DCHS struggled to find a solution to continuing operating losses, either through a sale of some or all of the Hospitals or a merger with a more financially sound partner. (*Id.* at ¶ 84.) All of these efforts failed. (*Id.)*

Despite continuous efforts to improve operations, operating losses continued to plague the health system due to, among other things, mounting labor costs, low reimbursement rates and the ever-changing healthcare landscape. (*Id.* at ¶ 86.) In 2013, DCHS actively solicited offers for several of the Hospitals and, to avoid failing debt covenants, the Daughters of Charity Foundation, an organization

separate and distinct from DCHS, donated $130 million to DCHS to allow it to retire some of its debts. (*Id.*)

DCHS explored and/or entered into a number of restructuring transactions over the ensuing five years, but, despite the infusion of capital and new management, it became apparent that the problems facing the Verity Health System were too large to solve without a formal court-supervised restructuring. (*Id.* at ¶ 95.) Thus, despite VHS' great efforts to revitalize its Hospitals and improvements in performance and cash flow, the legacy burden of more than a billion dollars of bond debt and unfunded pension liabilities, an inability to renegotiate collective bargaining agreements or payor contracts, the continuing need for significant capital expenditures for seismic obligations and aging infrastructure, and the general headwinds facing the hospital industry made success impossible without the filing of the Chapter 11 Cases. (*Id.*)

**B. Debtors' Liabilities and Unsustainable Debt Burden**

Over the course of this 15-year period of financial distress, the Debtors amassed what has proven to be an unsustainable debt burden. VHS, VBS, and VHS' five acute care hospital subsidiaries (*i.e.*, O'Connor Hospital, Saint Louise Regional Hospital, St. Francis Medical Center, St. Vincent Medical Center, Seton Medical Center/Seton Medical Center Coastside) are jointly obligated parties on approximately $461.4 million in outstanding secured debt, consisting of (a)

$259.4 million in outstanding principal amount of tax exempt revenue bonds, Series 2005 A, G and H issued by the California Statewide Communities Development Authority (the "2005 Bonds"); and (b) $202 million in outstanding principal amount of tax exempt revenue notes, Series 2015 A, B, C, and D and Series 2017 issued by the California Public Financing Authority (the "Working Capital Notes"). (App. Tab 3 (Chou Decl.) at ¶ 4.)

Holdings, a direct subsidiary of its sole member VHS, was created in 2016 to hold and finance VHS' interests in six (6) medical office buildings whose tenants are primarily physicians and medical groups affiliated with certain of the Hospitals operated by the Debtors. (*Id.* at ¶ 6.) Holdings is the borrower of approximately $66 million on two series of non-recourse financings secured by separate deeds of trust and revenue and accounts pledges, including lease rents on medical buildings (the "MOB Financing"). (*Id.*) The secured lenders for the MOB Financing are affiliates of NantWorks, LLC, which is an affiliate of the Debtors' prepetition manager, Integrity Healthcare, LLC. (*Id.*)

Debtor Seton Medical Center is liable for repayment of $20 million of limited obligation tax exempt bonds issued in September 2017 by the California Statewide Communities Development Authority (the "Clean Fund Bonds"). (*Id.* at ¶ 7.) The Clean Fund Bonds were issued to assist with clean energy-related capital

improvements to Seton Medical Center. No other Debtor is liable for repayment of the Clean Fund Bonds. (*Id.*)

Debtor Seton Medical Center is also liable for repayment of $20 million in California 30-year tax exempt bonds, issued in September 2017 for the purpose of seismic improvements at Seton Medical Center (the "NR2 Petros Bonds"). (*Id.* at ¶ 8.) No other Debtor is liable for repayment of the NR2 Petros Bonds. (*Id.*)

Finally, NantCapital, LLC has provided $40 million in unsecured debt financing for VHS, as reflected in two $20 million unsecured notes dated March 7, 2018 and March 29, 2018 (the "Unsecured Notes"). (*Id.* at ¶ 9.) Inclusive of the Unsecured Notes, the Debtors have approximately $500 million in total unsecured debt, including disputed, unliquidated or contingent claims, which are comprised of claims made by vendors of goods and services, cost report payables, pension obligations, management fees, and incurred but not reported third party-claims, many of which have been asserted by or on behalf of the many employees and independent contractors (*e.g.*, nurses, doctors, lab technicians, and other support personnel) who have kept the Hospitals open and operating to date. (App. Tab 4 (First Day Declaration) at ¶ 127.)

As of the Petition Date, the Debtors had approximately $40 million of unencumbered cash on hand, which was not subject to control accounts in favor of

any of the 2005 Bonds, the Working Capital Notes, or the MOB Financing (excluding cash held on account of the Clean Fund Bonds and/or the NR2 Petros Bonds). By contrast, (i) all of the Debtors' income is subject to prepetition perfected pledges; and (ii) the gross revenue of the Hospitals is pledged in favor of the 2005 Bonds. (App. Tab 3 (Chou Decl.) at ¶ 10.)

### C. Bankruptcy Court Approves DIP Facility for Sole Benefit of Prepetition Secured Creditors

The Bankruptcy Court found that the Debtors had established the need for the proposed financing from the DIP Lender and entered the Final DIP Order approving the DIP Facility and, in so doing, facilitated the sale of the Prepetition Secured Creditors' collateral at the expense of the unsecured creditors. (App. Tab 29 (Final DIP Ruling) at 8, 9-10, 11; App. Tab 34 (Final DIP Order) at ¶¶ 1, 2(b), 5(f); App. Tab 3 (Chou Decl.) at ¶ 28; App. Tab 35 (10/3/2018 Transcript) at 49.)

### D. Prepetition Secured Creditors Are Granted Adequate Protection Required to Facilitate Sale of Their Collateral at Expense of Unsecured Creditors As to Whom Important Protections Granted By Bankruptcy Code Are Waived

In the course of authorizing the Debtors to enter into the DIP Facility, the Bankruptcy Court also found that the Prepetition Secured Creditors, whose liens were being primed by the DIP Facility, were adequately protected. (App. Tab 29 (Final DIP Ruling) at 9-10.) The Court reached this conclusion based on an

adequate protection package that had three components and was predicated on a number of dubious findings. (*Id.*)

*First*, the Bankruptcy Court found that the Prepetition Secured Creditors were protected by an equity cushion that existed between the value of the Debtors' assets and the value of the secured claims against those assets. (App. Tab 29 (Final DIP Ruling) at 9.) Based on the testimony presented by the Debtors, the aggregate secured debt on the Debtors' balance sheet as of the Petition Date was approximately $565 million, whereas the approximate realizable value of the Debtors' assets, in excess of prepetition secured liabilities, was between $150 and $225 million. (*Id.*) Thus, the Prepetition Secured Creditors were protected by an equity cushion of between 26% to 40%, which—according to the Bankruptcy Court acting in reliance on precedent holding that an equity cushion of 20% or more in and of itself constitutes adequate protection—provided adequate protection to the Prepetition Secured Creditors. (*Id.*); *see, e.g.*, *In re James River Assocs.*, 148 B.R. 790, 796 (E.D. Va. 1992) ("The amount of equity cushion sufficient to adequately protect the creditor is determined on a case-by-case basis. . . . However, the reported cases do provide some guidance: Case law has almost uniformly held that an equity cushion of 20% or more constitutes adequate protection. . . . Case law has almost as uniformly held that an equity cushion under 11% is insufficient

to constitute adequate protection. . . . Case law is divided on whether a cushion of 12% to 20% constitutes adequate protection.").

*Second*, the Bankruptcy Court found that, in addition to the adequate protection furnished by the equity cushion, the Prepetition Secured Creditors were adequately protected by the replacement liens and superpriority claims as to all of the Debtors' assets (encumbered and unencumbered) to be granted to them under the Final DIP Order. (App. Tab 29 (Final DIP Ruling) at 9-10.)

*Third*, any doubt as to the sufficiency of the adequate protection furnished to the Prepetition Secured Creditors was extinguished by an array of additional protections provided to these secured creditors under the Final DIP Order, including, most notably, the Section 506(c) Waiver and the Section 552(b) Waiver. (*Id*. at 11.) The Bankruptcy Court concluded that such waivers were "necessary to induce the DIP Lender to extend the financing" because "the Debtors [were] in a dire financial position," and, without such concessions, could not have "negotiated a financing package containing such favorable terms."[2] (*Id*.)

This conclusion bears further scrutiny. It explains why the DIP Lender, who was putting in new money, was granted comparable section 506(c)

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[2] The Bankruptcy Court's conclusion in this respect is somewhat perplexing. Contrary to the Court's major premise, the Prepetition Secured Creditors, unlike the DIP lenders in the cases on which it relies, are not extending any credit to the Debtors. (App. Tab 3 (Chou Decl.) at ¶ 7.) It is the DIP Lender, Ally Bank, that is providing the requisite post-petition financing, while the Prepetition Secured Creditors, who were offered but declined the opportunity to provide such financing, sought out the adequate protection they received simply to sit out the Chapter 11 Case. (*Id.*)

and 552(b) waivers to which Committee did not object, but not why the Prepetition Secured Creditors, whom the Bankruptcy Court had found were already fully protected by an equity cushion in excess of 25%, were granted the Section 506(c) and 552(b) Waivers. Nor does it explain why these waivers were granted when the Bankruptcy Court had also found (i) on the one hand, that "[t]here [was]s no evidence before the Court that the Debtors' assets are declining in value" (App. Tab 29 at 9-10); and (ii) on the other, that (a) "the Debtors' financial position [was] not strong; (b) the Debtors' financial prospects were "dire"; and (c) "the Debtor[s] [were] hemorrhaging money at an unsustainable rate." (*Id.* at 8, 11, 12.)

The first set of these findings argued for the conclusion, rejected by the Bankruptcy Court, that the Prepetition Secured Creditors, sitting atop their equity cushion and with no decline in collateral value on the horizon, had no need of adequate protection. In fact, the DIP Facility itself provided the best possible means of protecting the value of the Prepetition Secured Creditors' collateral so it could be sold.

The second set of findings, by contrast, left no doubt that there was an overwhelming need, which the Bankruptcy Court declined to recognize, to protect the Debtors' unsecured creditors against the vicissitudes of a debtor in "dire" financial condition that was "hemorrhaging" cash, by ensuring that they retained (or at least did not waive) all of the protections afforded to them under the

Bankruptcy Code, including the Section 506(c) Surcharge Right and the Section 552(b) Equites of the Case Exception.

## VI. ARGUMENT

### A. Bankruptcy Court Erred in Authorizing Section 506(a) and Section 552(b) Waivers Because Such Relief, As Component of Overall Adequate Protection Package, Was Not Narrowly Tailored To Circumstances of Chapter 11 Cases

The Bankruptcy Court erred, as threshold matter, in authorizing the Section 506(c) and Section 552(b) Waivers because such relief, viewed as a component of the overall adequate protection package for the Prepetition Secured Creditors, was not "narrowly tailored" to the circumstances of the Chapter 11 Cases, the Debtors, or the Prepetition Secured Creditors.

The purpose of adequate protection is to ensure that prepetition secured lenders receive the security they bargained for prior to the petition date. *See In re Sonora Desert Dairy,* 2015 WL 65301, at *11 (B.A.P. 9th Cir. Jan. 15, 2015) ("In other words, adequate protection is provided to ensure that the prepetition creditor receives the value for which the creditor bargained pre-bankruptcy"); *In re Ahlers*, 794 F.2d 388, 394 (8th Cir. 1986) ("Congress intended that a debtor's offer of adequate protection should, as nearly as possible under the circumstances of the case, provide the creditor with its bargained-for rights."); *In re Park W. Hotel Corp*., 64 B.R. 1013, 1017 (Bankr. D. Mass. 1986) ("Derived

from the fifth amendment protection of property interest, adequate protection . . . constitutes a legislative attempt to reconcile the competing interests of debtors, who need freedom from harassing creditors in order to effectuate reorganizations, and secured creditors, who are entitled to some measure of protection for their bargained for property interest" (internal citations omitted).)

In thus protecting secured creditors' expectations, however, adequate protection must be narrowly tailored to the circumstances of the specific bankruptcy case to obviate secured creditors obtaining greater rights than those for which they bargained. *See In re Am. Mariner Indus., Inc*., 27 B.R. 1004, 1006-07 (B.A.P 9th Cir. 1983) ("[U]ltimate meaning of the term [adequate protection] will be developed in a case-by-case basis, in each instance with the relief being tailored to the fact situation") (quoting 2 *Collier on Bankruptcy* (15th Ed.) § 361.01[1] (1983)); *In re Pelham Street Assocs.*, 131 B.R. 260, 263 (Bankr. D. R.I. 1991) ("'[A]dequate protection' under the Code is a flexible concept, to be tailored to the particular facts and circumstances of each case*"); In re Briggs Transp. Co.*, 35 B.R. 210, 217 (Bankr. D. Minn. 1983) ("A flexible definition of adequate protection is essential to insuring that the balance [Congress has struck between its policy in favor of the rehabilitation of debtors and the property rights of creditors] is tailored to the facts and circumstances of each case.")

The ultimate objective of providing adequate protection to prepetition secured parties is to preserve the *status quo*, not to better those parties' positions. Thus, where obtaining post-petition financing requires the furnishing of adequate protection to prepetition lenders under sections 361, 363, and 364 of the Bankruptcy Code, such relief must be carefully circumscribed to achieve only this objective, and no more. *See, e.g.*, *In re 354 E. 66th St. Realty Corp*., 177 B.R. 776, 782 (Bankr. E.D.N.Y. 1995) ("The purpose or intent of granting adequate protection payments [is] to maintain the *status quo* for that creditor and to protect the creditor from diminution or loss of the value of its collateral during the ongoing Chapter 11 case. If that creditor is oversecured or if there is no reason to believe that the collateral will diminish, then adequate protection payments may not be granted"); *In re Roe Excavating, Inc.*, 52 B.R. 439, 440 (Bankr. S.D. Ohio 1984) ("Adequate protection generally is meant to preserve the secured creditor's position at the time of bankruptcy.")

"Neither the legislative history nor the [Bankruptcy] Code indicate that Congress intended the concept of adequate protection to go beyond the scope of protecting the secured claim holder from a diminution in the value of the collateral securing the debt." *In re Pine Lake Vill. Apartment Co.*, 19 B.R. 819, 824 (Bankr. S.D.N.Y. 1982); *In re Orlando Trout Creek Ranch*, 80 B.R. 190, 191-92 (Bankr. N.D. Cal. 1987) (where value of collateral has appreciated during

chapter 11 case, "[i]t would be overcompensation to ignore this benefit in computing any sort of adequate protection"); *In re Bluejay Props., LLC*, 512 B.R. 390 (B.A.P 10th Cir.. 2014) ("[A]dequate protection is intended to protect against a decline in a creditor's security cushion; it is not intended to allow a creditor to improve the security cushion that it had at the time the bankruptcy petition was filed.")

As a consequence, a lender's entitlement to adequate protection arises only when there is evidence establishing likely loss to its collateral position as a result of a debtor's chapter 11 efforts. *See, e.g., RTC v. Swedeland Dev. Grp. (In re Swedeland Dev. Grp.)*, 16 F.3d 552, 564 (3d Cir. 1994) ("Whether protection is adequate 'depends directly on how effectively it compensates the secured creditor for loss of value' caused by the superpriority given to the post-petition loan."); *In re Saypol*, 31 B.R. 796, 800 (Bankr. S.D.N.Y. 1983) ("In the context of the automatic stay, Congress believed the existence *vel non* of such a decline [in the value of the secured creditor's interest] to be almost decisive in determining the need for adequate protection."); *In re Markos Gurnee P'ship*, 252 B.R. 712, 716 (Bankr. N.D. Ill. 1997), *aff'd sub nom. First Midwest Bank, NA v. Steege*, 1998 U.S. Dist. LEXIS 8410 (ND Ill. May 19, 1998) (only when secured creditor is "threatened with a decline in the value of its interest in the estate's property," must "the estate . . . take action to make up the decline" through adequate protection); *In*

*re Deico Elecs., Inc.*, 139 B.R. 945, 947 (B.A.P. 9th Cir 1992) ("Adequate protection prevents creditors from becoming more undersecured because of the delay that bankruptcy works on the exercise of their state law remedies.")

Due to a debtors' diminished capacity to negotiate financing on favorable terms, prepetition secured lenders will, if unchecked, sometimes seek adequate protection even where none is warranted, seeking to "extract favorable terms that harm the estate and creditors" especially "when the lender has a prepetition lien on cash collateral." *RTC v. Official Unsecured Creditors Comm. (In re Defender Drug Stores Inc.)*, 145 B.R. 312, 317 (B.A.P. 9th Cir. 1992) (citing *In re Ames Dep't. Stores, Inc.*, 115 B.R. 34, 38 (Bankr. S.D.N.Y. 1990)); *In re Tenney Vill. Co.*, 104 B.R. 562, 567-70 (Bankr. D.N.H. 1989).

Arguments about the need to "induce" lenders to lend (or not object to loans from other lenders) notwithstanding, such efforts to obtain adequate protection where none is required should be resisted because to do otherwise would afford secured lenders unwarranted control over the course of chapter 11 cases and permit them to improperly usurp the mandated roles of the court, the debtors, and any committee in the chapter 11 process. (App. Tab 29 (Final DIP Ruling) at 11 (Bankruptcy Court holding that adequate protection package was "necessary to induce the DIP Lender to extend financing"); *see, e.g., In re Tenney Vill. Co., Inc.*, 104 B.R. at 568 (debtor-in-possession financing terms must not

"pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit" of the secured creditor; to do so would permit secured creditors to "run roughshod over numerous sections of the Bankruptcy Code"); *Gen. Elec. Capital Corp. v. Hoerner (In re Grand Valley Sport & Marine, Inc.)*, 143 B.R. 840, 852 (Bankr. W.D. Mich. 1992) ("[T]his court will not authorize post-petition financing pursuant to § 364 where a creditor leverages a debtor in possession into making a concession unauthorized by, or in conflict with, the Bankruptcy Code as a condition for the requested credit"); *In re Berry Good, LLC*, 400 B.R. 741, 747 (Bankr. D. Ariz. 2008) ("[B]ankruptcy courts do not allow terms in financing arrangements which convert the bankruptcy process from one designed to benefit all creditors to one designed for the unwarranted benefit of the post-petition lender").

Thus, prior to approving the terms of a DIP financing and any related adequate protection—such as the Section 506(b) and 552(b) Waivers at issue here—a bankruptcy court must ensure that the proposed relief will not "skew the carefully designed balance of debtor and creditor protections that Congress drew in crafting Chapter 11" by approving postpetition financing on terms that "prejudice, at an early stage, the powers and rights that the Bankruptcy Code confers for the benefit of all creditors." *Ames*, 115 B.R. at 37-38; *see also Tenney Vill.*, 104 B.R.

at 568 (stating that postpetition financing should not be approved where effect is to "disarm the [d]ebtor of all weapons usable against it for the bankruptcy estate's benefit, place the [d]ebtor in bondage working for the Bank, seize control of the reins of reorganization, and steal a march on other creditors in numerous ways").

It was critical for the Bankruptcy Court to have ensured that the terms of the DIP Facility, and accompanying adequate protection for the Prepetition Secured Creditors, did not impair the ability of either the Debtors or the Committee to discharge their duties fully.[3] The Section 506(c) and 552(b) Waivers, by precluding the Debtors from (i) recovering from the Prepetition Secured Creditors' collateral "the reasonable, necessary costs of preserving, or disposing of, such property"; and/or (ii) accessing post-petition the "proceeds" of such prepetition collateral, resulted in just such impairment. 11 U.S.C. §§ 506(c), 552(b).

[3] Worth noting is the fact that the Committee, the Appellant herein, is the fiduciary with the greatest interest in preserving the Debtors' access to the Section 506(c) Surcharge Right and Section 552(b) Equities of the Case Exception. There are two fiduciaries in these Chapter 11 Cases, the Debtors and the Committee, each with very different mandates. The Debtors, as the chapter 11 management of a California not-for-profit enterprise, have duties that run in favor of the Debtors' ongoing "mission." *See In re United Healthcare Sys., Inc.*, 1997 WL 176574, at *5 (D.N.J. Mar. 26, 1997) ("The officers and directors of a nonprofit organization are charged with the fiduciary obligation to act in furtherance of the organization's charitable mission."); *Summers v. Cherokee Children & Family Servs.*, 112 S.W.3d 486, 504 (Tenn. Ct. App. 2002) ("[N]onprofit directors must be 'principally concerned about the effective performance of the nonprofit's mission"'). Conversely, the Committee, as the statutorily appointed representative of the Debtors' unsecured creditors, has duties running in favor of such creditors. *In re Caldor, Inc. NY*, 193 B.R. 165, 169 (Bankr. S.D.N.Y. 1996) ("A creditors committee stands as a fiduciary to the class of creditors it represents") (citing cases). Importantly, the board of a not-for-profit debtor does not have the same duties with respect to, or focus on, stakeholder value as do the boards of for-profit debtors. *See* John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties & Accountability*, 35 Vt. L. Rev. 117, 126 (2010) ("The clarity and certainty of purpose for exempt organizations focuses not on shareholder value but on faithfulness to the charitable exempt purposes as defined by law and declared by the organization, which helps distinguish these entities from for-profit operations.").

While there may be circumstances where the relevant secured lenders' protection is truly "inadequate," under which circumstances such waivers and the resulting impairment might be warranted, such circumstances did not exist where, as here, (i) the Court found that the claims of the Prepetition Secured Creditors were significantly oversecured; (ii) the Prepetition Secured Creditors were granted replacement liens and superpriority claims, such that the Debtors did not retain any unencumbered assets; (iii) but for the replacement liens, the Debtors had a substantial amount of unencumbered assets available for distribution to unsecured creditors; and (iv) the Debtors' unsecured creditors have consequently been compelled to fund the costs of the liquidation of the Prepetition Secured Creditors' collateral. (App. Tab 3 (Chou Declaration) at ¶ 8; App. Tab 29 (Final DIP Ruling) at 9-10); s*ee, e.g., In re Bluejay Props., LLC,* 52014 Bankr. LEXIS 949 at *14-15 (B.A.P. 10th Cir. Mar. 12, 2014) (affirming denial of additional adequate protection where secured creditor was "not just oversecured by the Property; the bankruptcy court granted [the secured creditor] a replacement lien in future Property rents and also ordered Debtor to . . . mak[e] contract interest payments to Bank"; additional relief denied because "adequate protection is intended to protect against a decline in a creditor's security cushion; it is not intended to allow a creditor to improve the security cushion that it had at the time the bankruptcy petition was filed.")

To have granted the Section 506(c) and 552(b) Waivers under such circumstances was to take adequate protection too far. The adequate protection granted to the Prepetition Secured Creditors permitted them, in contravention of fundamental adequate protection principles, to plainly better their position. *See In re Pine Lake Village*, 19 B.R. at 824 ("Neither the legislative history nor the [Bankruptcy] Code indicate that Congress intended the concept of adequate protection to go beyond the scope of protecting the secured claim holder from a diminution in the value of the collateral securing the debt.") As a result, the package of concessions granted to the Prepetition Secured Creditors as "adequate protection"—to the extent it included the Section 506(c) and 552(b) Waivers—greatly exceeded the risk to their collateral position and, consequently, was unbalanced and improper.

To remedy this impropriety, greater protections should have been made available to the unsecured creditors, including by ensuring that the Section 506(c) Surcharge Right and the Section 552(b) Equities of the Case Exception remained available to the Debtors to permit their estates to recover for the benefit of unsecured creditors some or all of the funds that would be expended during the Chapter 11 Cases to support the Debtors' ongoing operations for the sole benefit of Prepetition Secured Creditors. The Bankruptcy Court failed to do so, and, in so doing, erred as a matter law and fact by granting the Prepetition Secured Creditors

adequate protection that was not "narrowly tailored" to the rights of such secured creditors or the needs of the Debtors' unsecured creditors.

### B. Bankruptcy Court Erred in Granting Prepetition Secured Creditors Waiver of Debtors' Rights Under Section 506(c) of Bankruptcy Code Because Such Waiver Was Granted Without Regard to Congressional Intent or Facts of Chapter 11 Cases

The Bankruptcy Court erred in granting the Prepetition Secured Creditors a waiver of the Debtors' rights under section 506(c) of the Bankruptcy Code because—in addition to its inclusion in an overly broad adequate protection package that was not "narrowly tailored" to these Chapter 11 Cases—the Section 506(c) Waiver contravened Congressional intent regarding the balance between secured and unsecured prerogatives that is to be preserved in all chapter 11 cases. Section 506(c) exists for benefit of the debtor's estate and its unsecured creditors and can be waived for benefit of secured creditors only under very limited circumstances, none of which were present at the time of entry of the Final DIP Order. Left uncorrected, the practical effect of the Bankruptcy Court's approval of the Section 506(c) Waiver would be to eliminate a further avenue of recovery for the Debtors' estates and, as a result, to materially increase the prospect that the costs of the chapter 11 sale process that the Debtors conducted for the benefit of the Prepetition Secured Creditors would ultimately be borne by the unsecured creditors alone.

Section 506(c) was intended by Congress to insure that a secured creditor pays the costs associated with maintaining or disposing of its collateral during a bankruptcy case. *See, e.g., Precision Steel Shearing v. Fremont Fin. Corp. (In re Visual Indus., Inc.)*, 57 F.3d 321, 325 (3d Cir. 1995) (section 506(c) "is . . . designed to prevent a windfall to the secured creditor . . . . The rule understandably shifts to the secured party . . . the costs of preserving or disposing of the secured party's collateral, which costs might otherwise be paid from the unencumbered assets of the bankruptcy estate."); *In re Codesco, Inc.*, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) ("The underlying rationale for charging a lienholder with the costs and expenses of preserving or disposing of the secured collateral is that the general estate and unsecured creditors should not be required to bear the cost of protecting what is not theirs."); *In re Proto-Specialties, Inc.*, 43 B.R. 81, 83 (Bankr. D. Az. 1984) (same).

To address this contingency, section 506(c) authorizes a debtor to surcharge a secured creditor for the "actual" and "necessary" costs of preserving, and disposing of, the secured creditor's collateral, where such collateral is shown to be at risk of decline in value. 11 U.S.C. § 506(c); *see Proto-Specialties*, 43 B.R. at 83 (section 506(c) "expresses the equitable principle [that] a lienholder may be charged with the reasonable costs and expenses incurred to preserve or dispose of collateral, to the extent the secured party is benefited"); *In re Brown Bros.*, 136

B.R. 470, 474 (W.D. Mich. 1991) ("reasonableness of the expenses incurred" keyed to "amount that the holder of the security interest would have had to spend on its own behalf" to preserve its collateral).

Courts have rejected attempted waivers of surcharge rights under section 506(c) where the recoveries of a debtor's unsecured creditors have been shown to be at greater risk than those of its secured creditors. *See, e.g.*, *Hartford Fire Ins. Co. v. Norwest Bank Minn., N.A. (In re Lockwood Corp.)*, 223 B.R. 170, 176 (B.A.P. 8th Cir. 1998) (holding that provision in DIP financing order purporting to immunize lender from Bankruptcy Code section 506(c) surcharges was unenforceable and would create an improper windfall); *In re Colad Grp.*, 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005) (refusing to approve DIP financing with a section 506(c) waiver intact); *In re Brown Bros.*, 136 B.R. 470, 474 (W.D. Mich. 1991) (concluding that section 506(c) waiver "is not enforceable in light of the congressional mandate that a trustee have the authority to use a portion of secured collateral for its preservation or proper disposal"); *In re Willingham Invs., Inc.*, 203 B.R. 75, 80 (Bankr. M.D. Tenn. 1996) (cash collateral order could not properly render secured creditor collateral "immune from surcharge under § 506(c)"); *In re InteliQuest Media Corp.*, 326 B.R. 825, 830 n.31 (B.A.P. 10th Cir. 2005) (waiver of right to surcharge under section 506(c) is "against public policy and unenforceable per se"); *In re Ridgeline Structures, Inc.*, 154 B.R. 831, 832 (Bankr.

D.N.H. 1993) (stipulation purporting to waive section 506(c) expenses "no matter what action, inaction, or acquiescence by [the secured party] might occur" (and which also failed to provide other creditors with the requisite objection period), was against public policy and unenforceable per se."); *In re Reese*, 2007 WL 4365777, at *1 (Bankr. N.D. Tex. Dec. 12, 2007) (declining to "deny the statutory right to surcharge upon arguments based solely on equity," and noting that "some bankruptcy courts believe that even a waiver of the right to surcharge under section 506(c) is "against public policy and unenforceable per se").

The Bankruptcy Court had every reason to do the same here, where (i) the Court found that the claims of the Prepetition Secured Creditors were significantly oversecured; (ii) the Prepetition Secured Creditors were granted replacement liens and superpriority claims, such that the Debtors did not retain any unencumbered assets; (iii) but for the replacement liens, the Debtors had a substantial amount of unencumbered assets that would otherwise have been available to the unsecured creditors; and (iv) the Debtors' unsecured creditors had consequently been compelled to fund the costs of the liquidation of the Prepetition Secured Creditors' collateral. (App. Tab 3 (Chou Declaration) at ¶ 8; App. Tab 29 (Final DIP Ruling) at 9-10.)

The Bankruptcy Court's failure to do so gave away, without an adequate basis for doing so, a potential recovery for unsecured creditors. Invoking

a competing line of cases, the Bankruptcy Court approved the Section 506(c) Waiver solely on the basis that it was necessary to "induce the DIP Lenders to extend the necessary credit." (App. Tab 29 (Final DIP Ruling) at 11); *see, e.g.*, *In re Metaldyne Corp*., 2009 WL 2883045, at *1 (Bankr. S.D.N.Y. June 23, 2009) (rejecting challenge to section 506(c) waiver because relevant secured lenders were "funding these cases, and should not be surcharged for the privilege of doing so"); *In re Antico Mfg. Co.*, 31 B.R. 103, 106 n.1 (Bankr. E.D.N.Y. 1983) (holding that the §506(c) waiver was "not so detrimental or improper as to jeopardize the loss of the entire financing package").

The Bankruptcy Court's rationale glossed over the fact that the Prepetition Secured Creditors, unlike the DIP lenders in the cases on which it relies, were not extending any credit to the Debtors. (App. Tab 3 (Chou Decl.) at ¶¶ 17, 26.) It is the DIP Lender, Ally Bank, that was providing the requisite post-petition financing, while the Prepetition Secured Creditors, who were offered but declined the opportunity to provide such financing, sought out the adequate protection they received simply to sit out the Chapter 11 Cases and ride the coattails of the DIP Lender to maximize their recovery. (*Id.* ¶ 17.) Under such circumstances, the "inducement" arguments on which the Bankruptcy Court predicated its decision necessarily fall by the wayside.

The waiver of the Section 506(c) Surcharge Right was particularly problematic under circumstances, such as those found in the Chapter 11 Cases, where the sole objective of the chapter 11 process has been to liquidate the Debtors' assets for the exclusive benefit, in the first instance, of the Prepetition Secured Creditors. With the Hospitals "hemorrhaging cash," a finite amount of credit available under the DIP Facility, and any recoveries for the unsecured creditors dependent on the "rapid" consummation of a series of Hospital sales, a line very likely will be crossed, at a point not yet determined, when the entire process is being funded out of what might otherwise be unencumbered cash. (App. Tab 29 (Final DIP Ruling) at 12.) Without recourse to their Section 506(c) Surcharge Right, the Debtors' unsecured creditors would be without any recourse at all, in an inescapable and value-destructive quandary never intended by Congress when it enacted section 506(c).

### C. Bankruptcy Court Erred in Granting Prepetition Secured Creditors Waiver of Debtors' Rights Under Section 552(b) of Bankruptcy Code Because Such Waiver Was Granted In Contravention of Legislative Intent and Without Regard to Circumstances of Chapter 11 Cases

Finally, the Bankruptcy Court erred in granting the Prepetition Secured Creditors a waiver of the Debtors' rights under section 552(b) of the Bankruptcy Code because—in addition to the inclusion of this waiver in an adequate protection package that was not narrowly tailored to these Chapter 11

Cases—the Section 552(b) Waiver was granted without regard to either Congressional intent or the particular facts of these Chapter 11 Cases. Section 552(b)'s protections, no less than those available under section 506(c), exist for benefit of the Debtors' estates and their unsecured creditors and can be waived for benefit of secured creditors only under very limited circumstances, none of which were present at the time of entry of the Final DIP Order. (App. Tab 29 (Final DIP Ruling) ¶ 5(e).) Under the current facts, there is no reason that the Prepetition Secured Creditors should benefit from the Debtors' gratuitous waiver of this important right, particularly at the unsecured creditors' expense.

Section 552(b) provides that "if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case. . . *except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.*" 11 U.S.C. § 552(b) (emphasis added). The purpose of the Section 552(b) Equities of the Case Exception (as reflected in language of section 552(b) highlighted above) is "to prevent a secured creditor from reaping benefits from collateral that has

appreciated in value as a result of the trustee's/debtor-in-possession's use [*i.e.*, including the value of any services rendered or labor performed by the debtor in connection therewith] of the of other estate assets (which normally would go to general creditors) to cause the appreciated value." *In re Muma Servs.*, 322 B.R. 541, 558-59 (Bankr. D. Del. 2008).

It is, as a general matter, inappropriate for a debtor to foreclose this potentially valuable source of recovery for unsecured creditors by waiving its rights under the Section 552(b) Equities of Case Exception for the benefit of secured creditors. If unencumbered assets are used, at any point in a chapter 11 case, to maintain or increase the value of that collateral, unsecured creditors should be able to argue that such value inures to them, and not to the prepetition secured creditors. *See, e.g., In re Metaldyne Corp.*, 2009 WL 2883045, at *6 (Bankr. S.D.N.Y. June 23, 2009) ("[T]he Court, in its discretion, declines to waive prospectively an argument that other parties in interest may make."); *Stanziale v. Finova Capital Corp. (In re Tower Air, Inc.)*, 397 F.3d 191, 205 (3d. Cir. 2005) (section 552(b) prevents secured creditors from benefitting from collateral that has appreciated in value as a result of the trustee's/debtor-in-possession's use of other assets of the estate).

Waiving the Section 552(b) Equities of the Case Exception in the first weeks of the Chapter 11 Cases, as the Bankruptcy Court did here, was even more

manifestly inappropriate. The Bankruptcy Court could not possibly have determined the "equities of the case" only weeks after the Petition Date, or ordered at that early date the elimination of a remedy that could be based on the "equities of the case" at a much later date. Thus, any finding of fact that prospectively waived the "equities of the case" exception set forth in section 552(b) could only have been premature. *See, e.g.*, *Sprint Nextel Corp. v. U.S. Bank Nat'l Ass'n (In re TerreStar Networks, Inc.)*, 457 B.R. 254, 272-73 (Bankr. S.D.N.Y. 2011) (denying request for 552(b) waiver as premature because factual record was not fully developed); *In re Metaldyne Corp*., 2009 WL 2883045, at *6 (declining to waive equities of the case exception in connection with approval of debtor's use of cash collateral); *In re Heilman*, 2010 WL 3909167 (Bankr. D. S.D. Sept. 29, 2010) ("because Debtors did not request relief under § 552(b)(1), which may only be granted after notice and a hearing, in their motion, any discussion of whether Debtors are entitled to such relief would be premature"). [4]

It was especially important for the Debtors to have retained their rights under the Section 552(b) Equities of the Case of Exception here for all the same reasons that the particular circumstances of these Chapter 11 Cases mandated that the Debtors retain their Section 506(c) Surcharge Right. Given that the sole

[4] At a minimum, the Final DIP Order waiver of the Debtor' section 552(b)'s rights should have been without prejudice to any party's rights to seek relief under section 552(b) based on any facts that arose after the date of the Final DIP Order. *See, e.g., In re Excel Maritime Carriers, Ltd.*, Case No. 13-23060-RDD, ECF No. 133 at p. 13 (Bankr. S.D.N.Y. Aug. 6, 2013) (containing such a reservation).

objective of the chapter 11 process has been to liquidate the Debtors' assets for the exclusive benefit, in the first instance, of the Prepetition Secured Creditors, and a line very likely will be crossed, at a point not yet determined, when the entire process is being funded out of cash of indefinite provenance, the Debtors must retain the right to argue that some or all of the Debtors' remaining cash should be excluded from the Prepetition Secured Creditors' collateral under the Equities of the Case Exception. Without recourse to the Equites of the Case Exception, the Debtors and their unsecured creditors would be stripped of yet another important right that Congress and controlling precedent intended for the Debtors and their unsecured creditors to always have at their disposal.

Thus, the Committee believes that the rights of all parties to argue that the Section 552(b) Equities of the Case Exception applies should be preserved and that the proposed waiver should have been deleted from the Final DIP Order. Waiving the Section 552(b) Equities of the Case Exception was inappropriate, and restoring it by reversing the Final DIP Order to remove this waiver will return to the Debtors' unsecured creditors a valuable tool that Congress intended to remain under the control of Debtors and their unsecured creditors for the duration of the Chapter 11 Cases.

## VII. CONCLUSION

For all the foregoing reasons, this Court should (i) reverse the Final DIP Order to extent that it granted to the Prepetition Secured Creditors the Section 506(c) Waiver and the Section 552(b) Waiver; (ii) modify the Final DIP Order to the extent necessary to ensure that it is "narrowly tailored" to the circumstances of the Chapter 11 Cases; and (iii) grant the Appellant such other and further relief as is just and proper.

DATED: March 14, 2019

MILBANK LLP

*/s/ Gregory A. Bray*

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## CERTIFICATE OF COMPLIANCE

Pursuant to Federal Rules of Bankruptcy Procedure Rule 8015(a)(7), the undersigned certifies that the Appellant's Opening Brief complies with the type volume limitation and that the Appellant's Opening Brief contains 9,316 words (excluding the cover page, tables, signature blocks and required certificates) as counted by the computer program used to prepare the Appellant's Opening Brief.

DATED: March 14, 2019

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# APPENDIX OF STATUTES, RULES AND REGULATIONS
## (Federal Rule of Bankruptcy Procedure 8014(d))

## 11 U.S. Code § 361 - Adequate protection

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

**(1)**
requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

**(2)**
providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

**(3)**
granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

(Pub. L. 95–598, Nov. 6, 1978, 92 Stat. 2569; Pub. L. 98–353, title III, § 440, July 10, 1984, 98 Stat. 370.)

## 11 U.S. Code § 506 - Determination of secured status

**(a)**

**(1)**
An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

**(2)**
If the debtor is an individual in a case under chapter 7 or 13, such value with respect to personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing. With respect to property acquired for personal, family, or household purposes, replacement value shall mean the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined.

**(b)**

To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.

**(c)**

The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.

**(d)** To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—

**(1)**
such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or

**(2)**
such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

(Pub. L. 95–598, Nov. 6, 1978, 92 Stat. 2583; Pub. L. 98–353, title III, § 448, July 10, 1984, 98 Stat. 374; Pub. L. 109–8, title III, § 327, title VII, § 712(d), Apr. 20, 2005, 119 Stat. 99, 128.)

## 11 U.S. Code § 552 - Postpetition effect of security interest

**(a)**

Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

**(b)**

**(1)**
Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

**(2)**
Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

(Pub. L. 95–598, Nov. 6, 1978, 92 Stat. 2602; Pub. L. 98–353, title III, § 466, July 10, 1984, 98 Stat. 380; Pub. L. 103–394, title II, § 214(a), Oct. 22, 1994, 108 Stat. 4126; Pub. L. 109–8, title XII, § 1204(2), Apr. 20, 2005, 119 Stat. 194.)