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

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

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
LOS ANGELES DIVISION

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

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I. INTRODUCTION

At its core, this appeal is about who should bear the cost of the Chapter 11 Cases[1]—and when that determination should be made. The Bankruptcy Court, without any record whatsoever, wrongly determined that the unsecured creditors should bear all of the costs of the Chapter 11 Cases, even if they ultimately have no recovery because unencumbered assets otherwise available to them are used to benefit secured creditors exclusively. The Court issued that decision in the very first few days of the Chapter 11 Cases, even though much of the information relevant to such decision would not be known until much later in the cases and no evidence had been was offered about such potential information. The Bankruptcy Court complicated the matter further by finding, again without any evidence whatsoever, that the Prepetition Secured Creditors were "oversecured" as of the Petition Date. If true, the Prepetition Secured Creditors' consent to the DIP Facility, predicated on the Waivers (as defined below), was not required.

The Bankruptcy Code lays out a number of protections for unsecured creditors that shield them from the diversion of value otherwise available to them when such diversion ultimately benefits only secured creditors. Thus, for example,

[1] Capitalized terms not otherwise defined herein shall have the meaning ascribed to such terms in the Appellant Committee of Unsecured Creditors' Appellant's Brief [Dist. Ct. Docket No. 22].

section 506(c) of the Bankruptcy Code permits collateral to be surcharged to ensure that the lenders secured by such collateral pay the cost of preserving (and/or disposing of) the collateral, not the unsecured creditors. Section 552(b) similarly protects unsecured creditors by permitting the Court, based upon the "equities of the case," to allocate to unsecured creditors the value of collateral effectively created or realized after the Petition Date.

Here, on the Petition Date, the Prepetition Secured Creditors may not have held (subject to the results of an ongoing investigation by the Committee[2]) perfected security interests in more than $40 million of the Debtors' cash due to the lack of deposit control agreements. So, too, the Prepetition Secured Creditors may not have rights in all of the QAFs—"quality assurance fees" in the tens of millions of dollars payable by the State of California—which the Debtors might recognize one day. In as much as the value of those QAFs on the Petition Date will depend, in part, on postpetition activity, some of that value could ultimately be determined to be available to unsecured creditors under section 552(b) of the Bankruptcy Code.

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2 The Final DIP Order granted to Committee standing to investigate (the "Challenge Investigation") and challenge the validity, enforceability, and amount of the liens purportedly held by the Prepetition Secured Creditors (each proceeding seeking such relief, a "Challenge") within ninety (90) days from the formation of the Committee (Final DIP Order ¶ 5(e).) The Challenge Investigation remains ongoing.

The Bankruptcy Court wrongly agreed with the Debtors and the Prepetition Secured Creditors to eliminate these creditor protections, which would have afforded the unsecured creditors access to these and potentially other unencumbered assets, at the very outset of these Chapter 11 Cases. It did so on the theory that the Prepetition Secured Creditors had earned the right to the relevant waivers of section 506(c) (the "Section 506 (c) Waiver") and section 552(b) (the "Section 552(b) Waiver," and together with the Section 506(c) Waiver, the "Waivers") by agreeing to the Debtors' use of their cash collateral and permitting their prepetition liens to be primed by the DIP Facility.

But if—as the Bankruptcy Court found without any evidence as to market value—the Prepetition Secured Creditors were indeed oversecured, then their consent to use of cash collateral and the DIP Facility (conditioned, as it was, on the Waivers)—was not necessary. And, even if the Prepetition Secured Creditors were not oversecured, the Waivers were not appropriate given the lack of information at so early a stage in the Chapter 11 Cases as to a few important issues, such as how much in unencumbered assets actually existed and who would benefit most from their use to fund the Chapter 11 Cases.

What *was* known at of the time of the hearing on the Final DIP Order was that the Debtors continued to lose significant sums as a result of continuing operations during the Chapter 11 Cases. What *was not* known or disclosed was how much worse off the Prepetition Secured Creditors would have been if the Debtors had simply ceased operations at that time. The Prepetition Secured Creditors suggest that liquidation would have resulted in payment in full as to their claims, but it appears far more likely that the Prepetition Secured Creditors required continuing operations to unlock the value of their collateral; *i.e.*, the value of their collateral sold as a going concern would exceed the value of their collateral in liquidation because, among other reasons, the costs of terminating hospital operations are significant. (PSC App. Br. at 15-16.) But, to do so, the Debtors had to divert to this purpose both the value of otherwise unencumbered collateral *and* the proceeds of the DIP Facility. Indeed, regardless of whether they were oversecured or undersecured, the Prepetition Secured Creditors required the DIP Facility to realize value on their collateral; they were not burdened by it.

Likewise, the Court ignored that the Prepetition Secured Creditors probably could not simply foreclose on their collateral—hospitals and medical facilities—due to licensing and other regulatory requirements, such that continued operations were needed to sell the collateral in order for the Prepetition Secured Creditors to realize value from their collateral. Consequently, the Prepetition Secured Creditors, not unsecured creditors, should pay for such continuing operations.

What does this all mean? On a less than full record, the Bankruptcy Court found that the Prepetition Secured Creditors, whose claims were then and remain now subject to the Committee's ongoing Challenge Investigation, were not only secured, but oversecured *and* entitled to the Section 506(c) and Section 552(b) Waivers. The Bankruptcy Court so concluded even though such waivers were not, as a matter of law, needed if the Prepetition Secured Creditors were truly oversecured, as they contended and the Court found. Similarly, without any evidence, the Bankruptcy Court elected to bless at the very outset of the Chapter 11 Cases the waiver of protections that depended on a determination as to how things would turn out at the end of the chapter 11 process—such as the surcharging of collateral under section 506(c) and invocation of the Equities of the Case Exception—without knowing who would benefit, who would be harmed, in what amount, and on what conditions. In short, the Waivers were premature and unsupported by any relevant evidence or inquiry. In effect, what the Debtors agreed, and the Court approved, was to impose the cost of generating a "going concern premium" for the Prepetition Secured Creditors on the unsecured creditors without having the information required to properly undertake section 506(c) and section 552(b) analyses.

The very real possibility that Prepetition Secured Creditors will enjoy a substantial recovery in these Chapter 11 Cases while otherwise unencumbered assets will have been consumed in full, such that there is no recovery for unsecured creditors (or, at least, a recovery less than if the estates had simply liquidated at the outset of the Chapter 11 Cases) weighs heavily in favor of reversal of the Final DIP Order to the extent that it granted the Waivers. In just a few more months, the Bankruptcy Court and the key parties in interest will be in a position to understand, as they were not at the time of entry of the Final DIP Order, how much of the value of unencumbered assets was diverted, how much of the proceeds of the DIP Facility was used, and how the various creditor constituencies fared. With that information, the Bankruptcy Court could be, and, if the Final DIP Order is reversed, will be positioned to authorize the Debtors' estates to (i) exercise their Section 506(c) Surcharge Right to compensate those estates for any value diverted for the exclusive benefit of the Prepetition Secured Creditors and their collateral; and (ii) invoke the Equities of the Case Exception to allocate value created/preserved subsequent to the Petition Date.

As set forth more fully below, the arguments advanced by the Debtors and the Prepetition Secured Creditors do not overcome any of the foregoing objections; if anything, these arguments only further highlight the underlying problem—*i.e.*, the Bankruptcy Court waived protections afforded to unsecured creditors in reliance on an improper legal standard and without a full record as to the likely impact of such waivers—and it plainly erred in doing so.

- The Debtors' contention that the DIP Appeal is equitably and statutorily moot certainly does not do so. Not only are the issues raised by the Committee as to the Section 506(c) and 552(b) Waivers not moot, but, in fact, as explained above, the operation of section 506(c) and section 552(b) will not even come into play until conclusion of the Debtors' sale process and, contrary contentions notwithstanding, this Court can fashion "effective relief" to correct the Bankruptcy Court's error in this respect by restoring to the Debtors' estates access to section 506(c) and 552(b) for use at that time.

- Nor is the Prepetition Secured Creditors' argument that the Waivers were not prejudicial to the unsecured creditors because the Debtors' estates do not *currently* possess any viable claims under either section 506(c) or section 552(b) any more meritorious. The fact that the Debtors' estates may not be able to currently assert (and the Committee does not concede this assumption in the absence of any supporting evidence) section 506(c) and 552(b) claims does not mean that they will not be able to do so in the future, and it is anticipation of this contingency that the Section 506(c) Surcharge Right and the Section 552(b) Equities of the Case Exception should have been preserved.

- Similarly lacking in merit is the Debtors' and the Prepetition Secured Creditors' complaint that the Committee invoked the wrong standard of review in support of its arguments for reversal and, under the proper "abuse of discretion" standard, the Final DIP Order is not subject to challenge. Under any standard of review, however, the Bankruptcy Court clearly erred as a matter of law in granting the Waivers to what that court itself deemed to be oversecured and already adequately protected creditors in unnecessary derogation of the rights of the Debtors' unsecured creditors.

- Finally, the approval of Section 506(c) and Section 552(b) Waivers in other chapter 11 cases does not mandate their approval in these Chapter 11 Cases. Outcomes must follow circumstances, and the circumstances of these Chapter 11 Cases simply do not require the granting of comparable waivers.

For all the foregoing reasons, the Bankruptcy Court erred, as a matter of both law and fact in approving the Waivers, and, thus, the Final DIP Order must be reversed to the extent it granted the Waivers.

II. ARGUMENT

A. DIP Appeal Is Neither Equitably Nor Statutorily Moot; If Grant of Section 506(a) and Section 552(b) Waivers Is Reversed On Appeal, Effective Relief Can Be Fashioned by This Court

The Debtors contend that the DIP Appeal has been rendered equitably and/or statutorily moot as a result of (a) the DIP Lenders' reliance on the DIP Final Order and the Prepetition Secured Creditors' consent to priming by the liens granted to the DIP Lender under the DIP Facility; (b) the execution by the DIP Lenders and the Committee of a stipulation confirming that the DIP Appeal relates solely to the Waivers and will otherwise leave the Final DIP Order and the DIP Facility unaffected (the "DIP Lender Stipulation"); and (c) the Debtors' consensual use of the Prepetition Secured Creditors' cash collateral to, among other things, repay borrowings under the DIP Facility. (Debtor App. Br. at 19.) The Debtors are wrong on all counts.

The Debtors correctly observe that courts should consider the following four factors in determining whether an appeal is equitably moot: (1) whether a stay pending appeal was sought; (2) whether the relevant order has been substantially consummated; (3) the effect reversal or modification of the order will have on third parties not before the court; and (4) whether, in reversing or modifying the order, the court can fashion effective and equitable relief. *In re Transwest Resort*, 801 F.3d 1161, 1167-68 (9th Cir. 2015).

The Debtors also concede, as they must, that these factors almost invariably "pertain to an appeal from a bankruptcy court's confirmation order," but then go on to strain credulity by contending, without any on-point authority, that "certain of them are nonetheless relevant to an appeal from a DIP financing order." (Debtor App. Br. at 19.) Be that as it may, and notwithstanding any general applicability to "DIP financing orders," these factors have no applicability to the Section 506(c) or Section 552(b) Waivers.

As to the first factor, no request for a stay pending appeal was requested or required because, unlike in the case of the confirmation of a plan or the approval of DIP facility, the Section 506(c) and 552(b) Waivers were not intended to be immediately operative. *See In re Popp*, 323 B.R. 260, 271-72 (B.A.P. 9th Cir. 2005) (no request for stay necessary where effective relief can nonetheless be granted because transaction was not "complex" or "difficult to unwind"). Indeed, it remains unclear whether, if ever, the Waivers will be invoked. Thus, there was no reason for the Committee to seek a stay pending appeal as to rights that were not likely to be exercised until after disposition of the DIP Appeal.

The second and third factors, which relate to "substantial consummation" of the relevant Order and impact on third parties of potential reversal of the relevant Order, are no more applicable. While certain aspects of the Final DIP Order may be said to have been "substantially consummated" (*e.g.*, as to the disbursement of proceeds thereunder and the protections flowing to the DIP Lender as result), the same cannot be said as to the Waivers (*i.e.*, protections afforded under the Final DIP Order to the Prepetition Secured Creditors (not the DIP Lender) that have not yet, and may never be, invoked). *See In re Riviera Drilling & Exploration Company*, 502 B.R. 863, 869 (B.A.P. 10th Cir. 2013) (transaction contemplated by confirmation order not "substantially consummated" where "plan administrator has assumed management of all estate property and has made substantial distributions under the Plan; but the centerpiece of the Plan, namely the sale of the lease interests . . . has not occurred.")

Nor is the third factor satisfied in any way. Able to point only to cases relating to the disbursement of proceeds or the use of cash collateral, the Debtors concede as much, stating that "the Committee has not asked this Court to claw funds back from third parties or the DIP Lender who have been paid with the Prepetition Secured Creditors' cash collateral." (Debtors App. Br. at 20 (citing *In re Samuel*, 2018 WL 3639047 (B.A.P. 9th Cir. July 31, 2018) (holding that an appeal of a cash collateral order is moot if the funds have been spent.").) Straining to make a broader "detrimental reliance" argument, the Debtors go too far in contending that any party that dealt with the Debtors in any way "in reliance on the Final DIP Order" must have all of its expectations protected, including as to continued operation of the Waivers. (Debtors App. Br. at 20.)

Finally, as to the fourth factor, the Court could clearly fashion "effective" and "equitable" relief if it elects to reverse the Final DIP Order. Contentions to the contrary notwithstanding, the Court could fashion such a remedy without "substantially threatening the future of these Chapter 11 Cases" because, as evidenced by the DIP Lender Stipulation (Debtor App. Tab 2), the DIP Appeal in no way jeopardizes the DIP Lender's rights or threatens the Debtors' access to additional borrowings under the DIP Facility. (Debtor App. Tab. 2, at 2.) To the contrary, the Committee agreed with the DIP Lender in that Stipulation—about which the Debtors complain without apparent point—that the DIP Lender's rights under the DIP Facility and for all other purposes, along with the rights of all other parties to the DIP Facility, would be *unaffected* by the outcome of the DIP Appeal. (*Id.*)

To the extent that the Debtors go on to contend that "in reality, the Committee has no control over the position of the Prepetition Secured Creditors or the Bankruptcy Court with respect to what might happen in the event this Court reverses the decision below and vacates a portion of the Final DIP Order," the

Debtors venture recklessly into a world of speculation. (Debtors App. Br. at 21.) Yes, one or more of the Prepetition Secured Creditors could withdraw its consent and deny access to its cash collateral, but speculation to this effect is no more credible or rational than speculation to the contrary.

More appropriate would be the assumption that it would not be economically rational, at this stage of the Debtors' Chapter 11 cases—especially now that all the Debtors' most material assets have been sold—for the Prepetition Secured Creditors to take such action and thereby undermine the final stages of a chapter 11 process that presents them with the best path to a material recovery on their claims. Indeed, this should be especially the case here because the Prepetition Secured Creditors, who are not licensed to operate medical facilities, are not ever likely to be able to foreclose on their collateral and thus have even fewer options than secured creditors in cases not involving regulated entities. This Court should assume that the Prepetition Secured Creditors are as likely to take *no action* as to *act to terminate* access to cash collateral, and, based on this assumption of non-interference, reverse the Final DIP Order to the extent required to remove approval of the Waivers.[3] And again, if the Prepetition Secured Creditors were oversecured as alleged and the Court found, then their consent simply was not required.

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[3] The Debtors' statutory mootness argument is no more meritorious. By its express terms, section 364(e) applies solely to DIP loans, not adequate protection grants. 11 U.S.C. § 364(e) ("The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or

B. Under Any Standard of Review, Bankruptcy Court Erred in Granting Prepetition Secured Creditors Section 506(a) and Section 552(b) Waivers Under All Circumstances of Chapter 11 Cases

Under any standard of review, the Bankruptcy Court clearly erred as a matter of law in granting the Waivers to what that court itself deemed to be oversecured and already adequately protected creditors in unnecessary derogation of the protections afforded to the Debtors' unsecured creditors.

Regardless of whether labeled abuse of discretion or *de novo* review,[4] the threshold question in this appeal is whether the Bankruptcy Court "identified" and "applied" the "correct legal rule" to the "relief requested." *People's Capital & Leasing Corp. v. Big3D, Inc. (In re Big3D, Inc.)*, 438 B.R. 214 (B.A.P. 9th Cir. 2010). It did not, because, in granting the Waivers under all of the circumstances

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any priority or lien so granted, to an entity that extended such credit in good faith.") In keeping with this premise, the precedent cited by the Debtors in support of their statutory mootness argument are cases that involve the extension of credit under section 364, not the approval of adequate protection under section 361 of the Bankruptcy Code. *See, e.g., In re Adam's Apple, Inc.*, 829 F.2d 1484 (9th Cir.1987) (addressing "interim financing agreement wherein the bank agreed to advance funds to a debtor"). Conceding that "authorizing use the of cash collateral" is not generally "synonymous with extending credit," the Debtors seek to establish a link to section 364 where none exists by pointing to a DIP Facility requirement that mandates that "all eligible expected receipts from prepetition cash collateral [are] to be used to immediately repay postpetition indebtedness." (Debtor App. Br. at 24.) Whether or not such a requirement exists, there is no necessary connection between any obligation of the Prepetition Secured Creditors with respect thereto and the grant of the Waivers, so the Debtors' statutory mootness argument must fail.

4 Taking issue with the Committee's reliance on a "mixed question of law and fact" standard of review, both the Debtors and the Prepetition Secured Creditors argue that "review by this Court must be subject to the abuse of discretion standard, and not a *de novo* review." (Debtors App. Brief at 10 (citing *In re Lee*, 2018 WL 7501124 *7 and *In re Sunnymead Shopping Ctr. Co.*, 178 B.R. 809, 814 (B.A.P. 9th Cir. 1995); PSC App. Br. at 25-29 (same).) However, regardless of what label is used, the threshold, and ultimately dispositive, question is, as set forth above, whether the court "identified" and "applied" the "correct legal rule" to the "relief requested. *In re Big3D, Inc.,* 438 B.R. at 217.

of these Chapter 11 Cases, it took adequate protection too far. The adequate protection granted to the Prepetition Secured Creditors permitted them, in contravention of fundamental adequate protection principles, to better their position. 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.

As set forth at length in the Committee Appellant Brief, 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.").

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 (N.D. 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" (emphasis added).)

In these Chapter 11 Cases, the Bankruptcy Court adopted and applied an entirely different legal standard. Presented with secured creditors that, in their own words, demanded an "adequate protection package that was intended to preserve their *status as oversecured creditors* having a collateral value (as determined by the Bankruptcy Court) that exceed[ed] their secured claim by 26% - 40%" (PSC App. Brief at 2 (emphasis added)), the Bankruptcy Court granted the Prepetition Secured Creditors adequate protection that went "beyond the scope of protecting the secured claim holder from a diminution in the value of the collateral securing the debt," thereby permitting them to "obtain[]greater rights than those for which they bargained." *In re Pine Lake Vill. Apartment Co*., 19 B.R. 819, 824 (Bankr. S.D.N.Y. 1982); *see In re 354 E. 66th St. Realty Corp*., 177 B.R. at 782 ("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"). It erred in so doing, and the Final DIP Order must be reversed to the extent required to correct such error.

C. Section 506(c) Surcharge and Section 552(b) Equities of Case Exception Rights Should Be Preserved Regardless of Whether Debtors' Estates Can Currently Assert Meritorious Claims Under Either Provision; Assessment of Merits of Such Claims on Full Factual Record, Which Was Not Available Upon Entry of Final DIP Order, Is a Matter For Another Day

The rights of the Debtors' estates with respect to any Section 506(c) Surcharge and the Section 552(b) Equities of Case Exception should be preserved regardless of whether the Debtors' estates can *currently* assert meritorious claims under either section 506(c) or section 552(b) of the Bankruptcy Code. The Prepetition Secured Creditors contend otherwise, arguing that, in light of what the Prepetition Secured Creditors contend is their currently oversecured status, the Debtors' estates lost nothing as a result of the Waivers—there are, at this point in time, no "viable" claims under either section 506(c) or 552(b), and the waivers were warranted because "the Debtors and their unsecured creditors would gain nothing by attempting to make a claim" under sections 506(c) or 552(b). (PSC Appeal Br. at 3.)

The Prepetition Secured Creditors' argument misses the point. The rights granted under section 506(c) and 552(b) are designed to operate retroactively, not prospectively, to redress the "balance" between secured and unsecured creditor rights that may be undone during the course of a chapter 11 case. *See, e.g., In Re Energy Cooperative, Inc.*, 55 B.R. 957 (Bankr. N.D. Ill.

1985) ("If, at the *end of the case*, there are no assets from which to pay administrative expenses beyond those subject to a valid secured claim," recourse may be had to section 506(c) application (emphasis added)); *In re Iberica Manufacturing, Inc*., 180 B.R. 707 (Bankr. D.P.R. 1995) ("Section 506(c) recovery is solely for the benefit of the estate thereby enlarging the pool of assets available *at the time of distribution*." (emphasis added)). The fact that the Debtors' estates may not be able to currently assert section 506(c) and 552(b) claims does not mean that they will not be able to assert such claims in the future, and it is anticipation of this contingency that the Section 506(c) Surcharge Right and the Section 552(b) Equities of the Case Exception should be preserved.

To be sure, the oversecured status that the Prepetition Secured Creditors argue ensures that unencumbered assets or the proceeds thereof will never be invaded to protect secured creditor collateral remains subject to ongoing re-evaluation, both as a result of the market price data made available by the sale process and the Committee's ongoing Challenge Investigation. 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, with the Debtors' estates' thereby furnishing a benefit to the newly *undersecured* Prepetition Secured Creditors that is clearly subject to surcharge under Section 506(c). (App. Tab 29 (Final DIP Ruling) at 12.)

It is in anticipation of reaching such a point of no return that recourse to Section 506(c) and 552(b) must be preserved. Without such recourse, the Debtors' unsecured creditors would be without any remedy or route back to the *status quo ante* at all, in an inescapable and value-destructive quandary never intended by Congress when it enacted sections 506(c) and 552(b).

Denial of the Waivers to the Prepetition Secured Creditors, by contrast, would not have comparably prejudicial consequences. Unlike the Debtors' unsecured creditors, who would be stripped entirely of the right to seek relief under sections 506(c) and 552(b), the Prepetition Secured Creditors would retain all of the rights granted to them under the Bankruptcy Code and relevant precedent to contest any section 506(c) or 552(b) claims asserted by the Debtors. (*See* PSC App. Br. at 15 (citing *Debbie Reynolds Hotel & Casino, Inc. v. Calstar Corp. (In re Debbie Reynolds Hotel & Casino, Inc.)*, 255 F.3d 1061, 1068 (9th Cir. 2001), for proposition that "the Section 506(c) standard is 'not an easy standard to meet'" insofar as it "subjects the debtor to an 'onerous burden of proof'"). If, in fact and at the end of the day, the Prepetition Secured Creditors remain, as they contend, oversecured and nothing but their own collateral has been used to fund the sale process, the Prepetition Secured Creditors will have no cause for concern—no "viable" surcharge or equities of the case claims would exist and neither the Debtors' estates nor the Committee would be likely to pursue what would otherwise be "futile" claims. (PSC App. Br. at 3.) If this proves not to be the case, then the Debtors' estates should retain the right to pursue section 506(c) and/or section 552(b) claims against the Prepetition Secured Creditors, regardless of whether they are oversecured or undersecured.

The Bankruptcy Court—in approving the Waivers three weeks into these Chapter 11 Cases and well before the time when the "balance" between secured and unsecured could be accurately assessed—was effectively putting the cart before the horse, and doing so without any evidence whatsoever as to relative harms. To undo this error in an "effective" and "equitable" fashion, access to the Section 506(c) Surcharge Right and the Section 552(b) Equities of the Case Exception should be restored to the Debtors' estates, with the Prepetition Secured Creditors retaining all of the rights to defend against such claims granted to them by the Bankruptcy Code and relevant precedent.

D. Approval of Section 506(c) and Section 552(b) Waivers in Other Chapter 11 Cases Does Not Warrant Their Approval in These Chapter 11 Cases; Outcomes Must Follow Circumstances

Finally, the approval of section 506(c) and section 552(b) waivers in other chapter 11 cases does not mandate their approval in these Chapter 11 Cases.

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).

In arguing otherwise, the Debtors and the Prepetition Secured Creditors contend that waivers of unsecured creditor rights under section 506(c) and section 552(b) are "customary" in chapter 11 cases and have been "routinely" granted both by "courts in the Ninth Circuit" and in "financing orders entered in some of the largest bankruptcy cases in the nation." (PSC App. Br. at 18-20; Debtor App. Br. at 37-39.) The Committee acknowledges that the approval of comparable waivers has been "not uncommon," but "not uncommon" does not mean "universal," and certainly does not mean "always," and each case where such waivers has been granted must be, and generally has been, assessed on its own merits. (Debtor App. Brief at 34.)

Subjected to case-by-case scrutiny, many of the cases to which the Debtors and the Prepetition Secured Creditor point as involving comparable (and "routinely" granted) waivers are distinguishable on a number of grounds, including, most significantly, the fact that (i) the prepetition and DIP lenders are one and the same; (ii) the relevant prepetition lenders were demonstrably "undersecured," not, as is the case with Prepetition Secured Creditors, presumptively "oversecured;" and (iii) the relevant debtors were not regulated entities, thereby making liquidation/foreclosure a viable threat and an additional ground on which to grant such waivers.

The Sears Financing Order, which leads the Prepetition Secured Creditors' list in this regard, presents a case in point. (PSC App. Br. at 20.) The senior DIP loan in that case was furnished not, as in these Chapter 11 cases, by an unaffiliated third party, but by a subset of the Sears debtors' prepetition ABL lenders. *In re Sears Holdings Corp., et al.*, Case No. 18-23538 (RDD) (Bankr. S.D.N.Y. Nov. 30, 2018) [ECF No. 7] at 3 ("Certain of the Debtors' lenders under the Prepetition ABL Facilities have agreed to support the Debtors' chapter 11 cases . . . [by] agree[ing] to provide up to $1.83 billion senior secured superpriority priming debtor in possession asset-based credit facility . . . with $300 million of new incremental capacity.") Under such circumstances, the DIP lenders that were beneficiaries of section 506(c) and 552(b) waivers as to both their DIP and non-DIP claims were not merely furnishing the "mathematical equivalent" of new credit, but were actually making available hundreds of millions of dollars in new credit and could, in fact, foreclose upon Sears' non-regulated assets in the event of a default, thereby necessitating the more extensive adequate protection package that included the relevant waivers. *See In re Spheris Inc.,* Case No. 10-10352 (KG), 2010 Bankr. LEXIS 5764, at *14-15 (Bankr. D. Del. Feb. 23, 2010) (granting 506(c) and section 552(b) waiver in final cash collateral and DIP financing order where DIP and prepetition lenders were same parties).

By contrast—and as an illustration of the lack of universality as to such matters—an order approving a second, "junior" DIP facility (the "<u>Junior DIP Order</u>") that was entered in the very same *Sears* chapter 11 cases granted section 506(c) and 552(b) waivers to the relevant junior DIP lenders, as DIP lenders, but expressly denied such protection to any DIP lender that also held prepetition claims and any prepetition lenders, with the relevant Junior DIP Order providing that "[f]or the avoidance of doubt, nothing herein shall be deemed a waiver of (a) the provisions of section 506(c) of the Bankruptcy Code, (b) any 'equities of the case' under section 552(b) of the Bankruptcy Code or (c) the equitable doctrine of 'marshaling' or any similar doctrine with respect to any prepetition liens." *In re*

Sears Holdings Corp., et al., Case No. 18-23538 (RDD) (Bankr. S.D.N.Y. Nov. 30, 2018) [ECF No. 1436] at ¶ 6. Many of the Junior DIP Lenders had also been second lien prepetition lenders to Sears, but, without any evidence as to the global priming impact of the Junior DIP Facility on the claims of such prepetition lenders, the *Sears* court had no reason or basis for granting section 506(c) and 552(b) waivers to the relevant prepetition lenders.

The other recent cases cited by the Debtors and/or the Prepetition Secured Creditors are equally inapposite. *See In re Gen. Motors Corp., et al.*, Case No. 09-50026(REG) (Bankr. S.D.N.Y. Jun. 25, 2009) [ECF No. 2529] at ¶ 4 (waiving only section 506(c) claims against two governmental lenders in their DIP lender capacity; no waivers as to any prepetition debt granted); *In re Gen. Growth Props., Inc.,* Case No. 09-11977 (ALG), 2010 Bankr. LEXIS 5552 (Bankr. S.D.N.Y. Jul. 22, 2010) (waiving section 506(c) and section 552(b) claims, but only as to DIP Lenders; no waivers as to any prepetition debt granted).[5]

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[5] The Debtors' and the Prepetition Secured Creditors' efforts to distinguish (or ignore entirely) the cases cited by the Committee where comparable waivers have been *denied* are no more effective. *See 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) (not challenging validity of decision, simply noting that similar prohibition on section 506(c) waivers "does not exist in the Ninth Circuit or in the Central District of California"); *In re Colad Grp.*, 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005) (contending holding is distinguishable without stating why); *In re Brown Bros.*, 136 B.R. 470, 474 (W.D. Mich. 1991) (acknowledging *Brown Brothers* is "the ***one*** district court that had found Section 506(c) waivers contrary to public policy"); *In re InteliQuest Media Corp.,* 326 B.R. 825, 830 n.31 (B.A.P. 10th Cir. 2005) (contending only that relevant dispute was decided on *res judicata*, not public policy grounds); *In re Ridgeline Structures, Inc.,* 154 B.R. 831, 832 (Bankr. D.N.H. 1993) (acknowledging section 506(c) waivers are addressed on case-by-case basis and can be denied where not warranted by the relevant facts); *In re Willingham Invs., Inc.*, 203 B.R. 75, 80 (Bankr. M.D. Tenn. 1996) (not distinguished by Debtors or

None of the precedent to which the Debtors and the Prepetition Secured Lenders point supports conclusively the proposition that section 506(c) and 552(b) waivers must be granted in all cases. Thus, this Court should reject any contentions to that effect and determine, instead and exclusively, whether the Waivers were warranted under all the circumstances of these Chapter 11 Cases.

III. CONCLUSION

For all the foregoing reasons, this Court should (i) reverse the Final DIP Order to extent that it granted the Waivers; and (ii) grant the Appellant such other and further relief as is just and proper.

DATED: April 29, 2019

MILBANK LLP

/s/ Mark Shinderman

GREGORY A. BRAY
MARK SHINDERMAN
JAMES C. BEHRENS
DENNIS C. O'DONNELL

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

Prepetition Secured Creditors); *In re Reese*, 2007 WL 4365777, at *1 (Bankr. N.D. Tex. Dec. 12, 2007) (not distinguished by Debtors or Prepetition Secured Creditors).

CERTIFICATE OF COMPLIANCE

Pursuant to Federal Rules of Bankruptcy Procedure Rule 8015(a)(7), the undersigned certifies that the Appellant's Reply Brief complies with the type volume limitation and that the Appellant's Reply Brief contains 6,400 words (excluding the cover page, tables, signature blocks and required certificates) as counted by the computer program used to prepare the Reply Brief.

DATED: April 29, 2019

MILBANK LLP

/s/ Mark Shinderman
GREGORY A. BRAY
MARK SHINDERMAN
JAMES C. BEHRENS
DENNIS C. O'DONNELL

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