Docket #3092 Date Filed: 9/18/2019

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GREGORY A. BRAY (Bar No. 115367)
gbray@milbank.com
MARK SHINDERMAN (Bar No. 136644)
mshinderman@milbank.com
DANIEL B. DENNY (Bar No. 238175)
ddenny@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 BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA – LOS ANGELES DIVISION

In re:

VERITY HEALTH SYSTEM OF CALIFORNIA, INC., *et al.*,

Debtors and Debtors In Possession.

Affects:

☑ All Debtors
☐ Verity Health System of California, Inc.
☐ O'Connor Hospital
☐ Saint Louise Regional Hospital
☐ St. Francis Medical Center
☐ St. Vincent Medical Center
☐ Seton Medical Center
☐ O'Connor Hospital Foundation
☐ Saint Louise Regional Hospital Foundation
☐ St. Francis Medical Center of Lynwood Foundation
☐ St. Vincent Foundation
☐ St. Vincent Dialysis Center, Inc.
☐ Seton Medical Center Foundation
☐ Verity Business Services
☐ Verity Medical Foundation
☐ Verity Holdings, LLC
☐ De Paul Ventures, LLC
☐ De Paul Ventures - San Jose Dialysis, LLC

Debtors and Debtors In Possession.

Lead Case No. 2:18-bk-20151-ER
Jointly Administered With:
CASE NO.: 2:18-bk-20162-ER
CASE NO.: 2:18-bk-20163-ER
CASE NO.: 2:18-bk-20164-ER
CASE NO.: 2:18-bk-20165-ER
CASE NO.: 2:18-bk-20167-ER
CASE NO.: 2:18-bk-20168-ER
CASE NO.: 2:18-bk-20169-ER
CASE NO.: 2:18-bk-20171-ER
CASE NO.: 2:18-bk-20172-ER
CASE NO.: 2:18-bk-20173-ER
CASE NO.: 2:18-bk-20175-ER
CASE NO.: 2:18-bk-20176-ER
CASE NO.: 2:18-bk-20178-ER
CASE NO.: 2:18-bk-20179-ER
CASE NO.: 2:18-bk-20180-ER
CASE NO.: 2:18-bk-20181-ER

Chapter 11 Cases

Hon. Ernest M. Robles

OFFICIAL COMMITTEE OF UNSECURED CREDITORS' OBJECTION TO MOTION OF THE DEBTORS FOR AN ORDER APPROVING PROPOSED DISCLOSURE STATEMENT AND OTHER RELIEF [DKT. 2995]

Hearing:
Date: October 2, 2019
Time: 10:00 a.m. (Pacific Time)
Location: Courtroom 1568
255 E. Temple St.
Los Angeles, CA 90012

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The Official Committee of Unsecured Creditors of Verity Health System of California, Inc., *et al*. (the "Committee"), appointed in connection with the chapter 11 cases of the above-captioned debtors and debtors-in-possession (the "Debtors"), hereby submits this objection (the "Objection") to the *Motion of the Debtors for an Order Approving: (I) Proposed Disclosure Statement; (II) Solicitation and Voting Procedures; (III) Notice and Objection Procedures for Confirmation of Debtors' Plan; and (IV) Granting Related Relief* (the "Motion")[1] [Docket No. 2995]. The Motion should be denied because (i) the *Debtors' Chapter 11 Plan of Liquidation (Dated September 3, 2019)* [Docket. No. 2993] (the "Plan") is unconfirmable on its face, and (ii) the *Disclosure Statement Describing Debtors' Chapter 11 Plan of Liquidation (Dated September 3, 2019)* [Docket No. 2994] (the "Disclosure Statement") does not contain adequate information to permit creditors to make an informed decision about the Plan.

I. PRELIMINARY STATEMENT

The Court should not enter an order approving the Disclosure Statement because the underlying Plan is not confirmable on its face. The *Debtors*' proposed Plan improperly interferes with and essentially terminates the *Committee's* pending litigation against the Secured Creditors[2] by proposing to allow and pay the Secured Creditors in full notwithstanding the litigation. Effectively, the Plan ignores completely the adversary actions even though the Court's Final DIP Order granted the Committee standing to investigate and prosecute the claims, the Committee has prosecuted those claims, and the Committee intends to continue prosecuting such claims.

In addition, and as set forth in the underlying complaints, the Secured Creditors are *not* entitled to payment in full because they do not have perfected security interests in all of the Debtors' assets which may very well render them undersecured: they lacked a perfected security interest in Debtors'

[1] Capitalized terms not otherwise defined herein shall have the meanings ascribed to them in the Motion, Disclosure Statement, and Plan.

[2] Secured Creditors means holders of Class 2 Secured 2005 Revenue Bond Claims, Class 3 Secured 2015 Notes Claims, and Class 4 Secured 2017 Revenue Notes Claims, all as defined in the Plan. Per the Section 1.A. of the Plan, the 2005 Revenue Bonds Trustee is Wells Fargo Bank, National Association; the 2015 Notes Trustee is U.S. Bank, National Association; the 2017 Notes Trustee is also U.S. Bank, National Association; and UMB Bank, N.A., is Master Trustee for obligations issued under that certain Master Indenture of Trust, dated as of December 1, 2001, as amended and supplemented to include the 2005 Revenue Bonds, 2015 Revenue Notes, and 2017 Revenue Notes.

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deposit accounts; they lack a perfected security interest in post-petition QAF Disbursements; and they do not have a lien on the Debtors' going concern value or premium. Also, the Secured Creditors do not have liens in much of the excess value of the medical office building ("MOB") assets (as explained further below).

The Plan is thus not confirmable on its face because it (a) allows claims in full notwithstanding pending adversary actions as to the extent, validity, and priority of the Secured Creditors' secured claims, and (b) pays the Secured Creditors in full even though they have significant deficiencies in their collateral package—which the Debtors failed to bring to the attention of this Court at the outset of these Cases.

Confirmation of the Plan here, moreover, would result in the imposition all of the costs of these bankruptcy cases on the unsecured creditors (who will be paid less than 5% of their claims), while all of the economic benefits of proceeding with these cases are reaped by the Secured Creditors. Indeed, the Secured Creditors would be paid in full notwithstanding their collateral deficiencies and even though they would have received far less—but for these bankruptcy cases—had they simply foreclosed. The Debtors' Plan would ensure that these bankruptcy cases are primarily for the benefit of the Secured Creditors, at the expense of other stakeholders.

The Plan also is not confirmable on its face because it provides exculpation for the Bond and Notes Trustee even though they are not fiduciaries of the estate or a member or representative of a statutorily appointed committee.

In addition, and as set forth more fully below, the Disclosure Statement fails to provide adequate information about a number of material issues, such as why the convenience class would be paid 4% and the impact thereof, and what creditors would receive in a hypothetical chapter 7 liquidation if the Secured Creditors were paid that to which they were entitled—not the amount they have asserted and which the Plan purports to allow.

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II. OBJECTION

A. The Court Should Not Approve the Disclosure Statement Because the Plan is Unconfirmable on Its Face

Courts generally will decline to approve a disclosure statement which describes a plan that is unconfirmable on its face. *See In re Silberkraus*, 253 B.R. 890, 899 (Bankr. C.D. Cal. 2000), *subsequently aff'd*, 336 F.3d 864 (9th Cir. 2003) ("There are numerous decisions which hold that where a plan is on its face nonconfirmable, as a matter of law, it is appropriate for the court to deny approval of the disclosure statement describing the nonconfirmable plan.") (citing cases); *In re Beyond.com Corp.*, 289 B.R. 138, 140 (Bankr. N.D. Cal. 2003) ("Because the underlying plan is patently unconfirmable, the disclosure statement may not be approved."); *In re Filex, Inc.*, 116 B.R. 37, 41 (Bankr. S.D.N.Y. 1990) ("A court approval of a disclosure statement for a plan which will not, nor [cannot], be confirmed by the Bankruptcy Court is a misleading and artificial charade which should not bear the imprimatur of the court.").

Here, the Debtors' Plan is unconfirmable on its face because it treats the Secured Creditors' claims (also referred to herein as the Secured Debt) as "allowed" when they are, in fact, not allowed and, moreover, would pay the Secured Creditors in full notwithstanding large deficiencies in their collateral package that may very well render them undersecured.

1) The Plan is Patently Unconfirmable Because It Improperly Treats The Secured Creditors' Claims as Allowed Even Though There is Pending Litigation against the Secured Creditors Regarding Those Claims

Under Section 502(a) of the Bankruptcy Code, a claim is deemed allowed unless a party in interest objects. Once an objection is made, the determination of whether the objection is well-founded is a judicial function to be exercised by the court. *See Chaussee v. Lyngholm (In re Lyngholm)*, 24 F.3d 89, 92 (10th Cir. 1994) ("Claims disputed in amount may be resolved by the bankruptcy court under 502(b) . . . .")

The Committee has objected to the Secured Creditors' claims by filing adversary complaints challenging the validity, priority, and scope of their liens. *See Moi v. Asset Acceptance LLC (In re Moi)*, 381 B.R. 770, 772 (Bankr. S.D. Cal. 2008) ("[A] claim objection is still a claim objection, whether raised by filed objection or by adversary"). Yet, the Plan purports to pay the Secured

Creditors' claims in full as if such claims were fully secured by the Debtors' assets, without challenge. Such purported allowance directly contradicts and ignores the objections filed by the Committee in its adversary complaints.[3]

Accordingly, the Plan is unconfirmable on its face because it would pay, on the Effective Date, claims that have not yet been allowed. A fundamental tenet of chapter 11 is that only *allowed* claims are entitled to a distribution. *In re Motors Liquidation Co.*, 591 B.R. 501, 515 (Bankr. S.D.N.Y. 2018) ("Only filed 'allowed claims' are entitled to distribution. *See* Fed. R. Bankr. P. 3021 (stating that 'distribution shall be made to creditors whose claims have been allowed . . . .'); *see also In re Nutri*Bevco, Inc.*, 117 B.R. 771, 778 (Bankr. S.D.N.Y. 1990) (holding that parties that do not have 'allowed claims against the Chapter 11 estate' were not entitled to receive a distribution under a chapter 11 plan of reorganization)."); *see also Dubios v. Atlas Acquisitions LLC (In re Dubois)*, 834 F.3d 522, 526 (4th Cir. 2016) ("The bankruptcy court may 'allow' or 'disallow' claims from sharing in the distribution of the bankruptcy estate. 11 U.S.C. § 502."). Contrary to the terms of the proposed Plan, the Secured Creditors should be entitled to a distribution as to the allowed amount of their claims only after the disputes regarding their claims have been resolved and allowed by the Court. *See In re Weiss-Wolf, Inc.*, 59 B.R. 653, 655 (Bankr. S.D.N.Y. 1986) ("[A] debtor must make provision for payment of disputed claims so that if and when allowed[,] the claims have reasonable assurance that they will receive [appropriate] treatment.").

2) The Plan is Not Confirmable on Its Face Because It Would Pay Secured Creditors in Full Notwithstanding Significant Deficiencies in Their Collateral Package Such That They May Be Undersecured and Not Entitled to Payment in Full

For the most part, Debtors are jointly and severally liable for the Secured Debt. That debt is secured by a lien on much, *but not all*, of the Debtors' assets. The Committee has filed adversary

[3] The Debtors' chart on page 43 of the Disclosure Statement (and Plan §§ 4.3(b), 4.4(b), and 4.5(b)) indicates Debtors' intention to pay the disputed Class 2 Secured 2005 Revenue Bond Claims, Class 3 Secured 2015 Notes Claim, and Class 4 Secured 2017 Revenue Note Claims virtually in full. To the extent that the Debtors are attempting to pay these claims less than in full, such discrepancies appear to be trivial discounts that amount to "artificial impairment" designed to manufacture compliance with 11 U.S.C. § 1129(a)(8).

complaints exposing significant defects in the Secured Creditors' collateral package,[4] as noted in the Disclosure Statement [page 39]:

> On June 13, 2019, the Committee filed adversary proceedings against U.S. Bank (Adv. Pro. No. 2-19-ap-01165-ER) and UMB Bank (Adv. Pro. No. 2-19-ap-01166-ER). In both adversary proceedings, the Committee seeks a determination that the applicable Trustee does not have a perfected security interest in deposit accounts, future Quality Assurance Payments and certain other assets.

The Committee has standing to prosecute these actions by virtue of, *inter alia*, paragraph 5(e) of the Final DIP Order entered by the Court on October 4, 2018. Therefore, it is not only the fact of pending litigation which prohibits "allowed" treatment of the Secured Creditor's claim until resolved by Court order (*see* 11 U.S.C. § 502(b)), it is also the fact that the Secured Creditors do not possess perfected security interests in all of the Debtors' assets that would justify 100% distributions on their claims.

As alleged in the underlying complaints against some of the secured creditors,[5] the Secured Creditors did not perfect their security interest in the Debtors' deposit accounts, which totaled $71 million on the Petition Date; the Secured Creditors do not have a lien on post-petition disbursements made to the Debtors from California's Hospital Quality Assurance Fee program, which total approximately $82 million; and the Secured Creditors have no perfected security interest in the going concern premium generated by these bankruptcy cases. In addition, the Secured Creditors should not be allowed to capture all of the going concern premium generated by these cases while the unsecured creditors bear all the related costs of administration. Moreover, the Secured Creditors do not have a lien in the excess value of the medical office buildings of approximately $40 million.

a) The Secured Creditors Have No Perfected Security Interest in Debtors' Deposit Accounts Because There Are No Deposit Account Control Agreements on the Accounts

The Secured Creditors' did not perfect their security interest in Debtors' deposit accounts, which totaled $71 million as of August 31, 2018 (the "<u>Petition Date</u>"), because they lack deposit

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[4] *See generally* First Amended Complaint for Determination of Validity, Priority, and Extent of Liens and Security Interests (Docket No. 30, Adv. Pro. No. 2:19-ap-01165-ER) and First Amended Complaint for Determination of Validity, Priority, and Extent of Liens and Security Interests (Docket No. 28, Adv. Pro. No. 2:19-ap-01166-ER).

[5] The challenge period for potential claims against Verity MOB Financing LLC and Verity MOB Financing II LLC has been extended. (Orders Approving Stipulations at Docket Nos. 3020 & 3021.) No adversary action is pending against them at this time.

account control agreements. While some of the funds that were in those accounts may represent identifiable cash proceeds of the Secured Creditors' pre-petition collateral (the "Prepetition Collateral"), there was a substantial amount of commingling with non-proceeds (such as charitable grants and donations and an unsecured loan).[6]

b) **The Secured Creditors Have No Lien In Post-Petition QAF Disbursements Because Such Disbursements Do Not Derive From and Do Not Constitute Proceeds of the Secured Creditors' Prepetition Collateral**

The Secured Creditors do not have a lien on post-petition disbursements made to Debtors from California's Hospital Quality Assurance Fee program (the "QAF Program," and the "Post-Petition QAF Disbursements"), which total approximately $82 million. The Post-Petition QAF Disbursements did *not* exist, and Debtors were *not* entitled to them, as of the Petition Date. Similarly, had the Secured Creditors foreclosed on their security, on or before the Petition Date, they would not have realized any value from these disbursements. Rather, the Disbursements were or will be paid by the State of California only because, post-petition, the Debtors continued to provide the services of doctors, nurses, and other healthcare workers and continued to pay statutory fees ("QAF Fees") into the State's Hospital Quality Assurance Revenue Fund. Accordingly, the Post-Petition QAF Disbursements are not proceeds of the Prepetition Collateral because the payments do not "derive" from, are not a "substitute" for, and are not "traceable" to, that collateral. The Disbursements derive entirely from the Debtors' post-petition "services" and "labor" upon which the Secured Creditors do not have a lien.[7]

There are four primary arguments as to why the Secured Creditors' liens do not extend to Post-Petition QAF Disbursements:

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[6] The existence of unencumbered cash on the Petition Date is relevant because (1) the Debtors have used unencumbered assets otherwise available to unsecured creditors to fund these cases for the benefit of Secured Creditors, (2) any argument that the value of the Secured Creditors' collateral has diminished over time must recognize that some of the deposit accounts should not be factored into the calculation, and (3) the Court was not informed of the defects in cash collateral at the time the DIP Financing and cash collateral orders were entered at the outset of these cases.

[7] The Committee recognizes that these issues are in dispute and must be resolved in the pending adversary actions. The Committee has proposed to expedite resolution of those proceedings.

1 *First*, the Post-Petition QAF Disbursements are not "proceeds" of any of the Prepetition
2 Collateral. In accordance with (1) Section 552(a)'s general prohibition on security interests in after-
3 acquired property, (2) the limited exception to that prohibition contained in Section 552(b), and (3),
4 the definition of "proceeds" under the California Commercial Code, a secured creditor has an interest
5 in proceeds of collateral only where the funds that comprise the alleged proceeds: (i) "derive" from
6 pre-petition collateral; (ii) are "traceable" to the pre-petition collateral; or (iii) "substitute" for the pre-
7 petition collateral on a post-petition basis. *See, e.g.*, *Financial Sec. Assurance v. Days Cal. Riverside*
8 *Ltd. P'ship (In re Days Cal. Riverside Ltd. P'ship)*, 27 F.3d 374 (9th Cir. 1994). The Post-Petition
9 QAF Disbursements satisfy none of those tests. Simply put, the sale of the Secured Creditors'
10 collateral—the hospital facilities, the then-existing accounts receivable, and the like—simply would
11 not have entitled the buyer to collect the Post-Petition QAF Disbursements.

12 *Second*, the Secured Creditors do not have perfected security interests in the Post-Petition QAF
13 Disbursements because their existence and value depend entirely on the post-petition labor of the
14 Debtors' employees. *See In re Cafeteria Operators, LP*, 299 B.R. 400, 403 (N.D. Tex. 2003)
15 (determining that restaurant revenues that were primarily the fruits of the restaurant staff's labor were
16 not proceeds of collateral because the revenue depended on the utilization of estate resources); *Arkison*
17 *v. Frontier Asset Mgmt., LLC (In re Skagit Pac. Corp.)*, 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004)
18 (holding that, under California law, a security interest does not attach to post-petition income earned
19 through a debtor's labor or service, citing *Cafeteria Operators*).

20 *Third*, the Post-Petition QAF Disbursements had no value to the Secured Creditors as of the
21 Petition Date because the Debtors, as was their right, could have ceased operations on the Petition
22 Date and, thereafter, would be ineligible to receive the QAF Disbursements. This is because the Post-
23 Petition QAF Disbursements were dependent on the Debtors' continued, post-petition compliance
24 with statutory requirements, including the post-petition payment of QAF Fees and the post-petition
25 provision of medical services.

26 *Fourth*, the Post-Petition QAF Disbursements had no value to the Secured Creditors as of the
27 Petition Date because the Secured Creditors were not licensed to operate hospital facilities. As a result,
28 even if the Secured Creditors had chosen to foreclose upon the Hospitals, they lacked the ability to

operate them in the manner required to become eligible to receive the Post-Petition QAF Disbursements.

c) **The Secured Creditors Have No Lien in the Going Concern Premium, the Value of the Debtors' Assets Over and Above the Value the Secured Creditors Would Have Recognized Had the Secured Creditors Foreclosed or the Debtors Ceased Operations, Because the Premium is Derived from Labor**

The Secured Creditors lack a perfected security interest in any going concern premium generated by these bankruptcy cases. That premium—for which the Secured Creditors can take no credit—arose as a result of the Debtors' continuing operations during the pendency of these Chapter 11 Cases, and depends entirely on the post-petition labor of the doctors, nurses, healthcare workers, and other employees of the medical facilities.

Courts uniformly recognize, as discussed above, that a security interest does not attach to post-petition revenue derived from the debtor's services and labor. *See, e.g.*, *In re Cafeteria Operators, LP*, 299 B.R. at 403; *Far East Nat'l Bank v. United States Tr. (In re Premier Golf Props., LP)*, 477 B.R. 767, 776 (B.A.P. 9th Cir. 2012) (fees charged by debtor golf course for use of course post-petition were not proceeds of collateral because they were largely the result of the debtor's labor and resources that included "mowing, planting, watering, fertilizing, and repairing the grass, raking sand traps, repositioning the holes, and retrieving golf balls from the range"); *In re Skagit*, 316 B.R. at 336 ("revenue generated by the operation of a debtor's business, post-petition, is not considered proceeds if such revenue represents compensation for goods and services rendered by the debtor in its everyday business performance").

Here, the going concern premium generated by these Chapter 11 Cases is unequivocally attributable to the Debtors' ongoing operations after the Petition Date, and without such services, there would be no Post-Petition QAF Disbursements, *i.e.*, the value did not derive from the hospital buildings and would not transfer with the sale of the buildings. The Secured Creditors obviously do not have a lien on labor, and should not be treated as if they did. Therefore, the delta between (i) the prices that would have been paid for the Debtors' assets if the Secured Creditors had foreclosed and/or the Debtors ceased operations, and (ii) the prices generated by the SCC Sale and SGM Sale (together, the "<u>Sales</u>") through these cases, does not belong to the Secured Creditors.

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d) **The Secured Creditors Have No Lien In the Medical Office Buildings that Secure the MOB Financing**

The MOB assets of the Debtors were separately financed and secured through two series of non-recourse financing, and the Secured Creditors do not have a lien in the MOB assets. After payment to the first-lien MOB Financing lenders of about $66 million, there appears to be about $40 million of excess value available to the estate, only a small portion of which is subject to the junior lien of one of the Secured Creditors. Consequently, the Secured Creditors do not have a lien in most of the excess value of the MOB assets.

3) The Plan—Which Would Provide a Windfall to Secured Creditors—Should Not Be Confirmed Because The Plan Does Not Require Secured Creditors to Pay The Costs Of These Chapter 11 Cases, Which Permitted An Increase In the Value to be Recognized From Their Collateral

The Secured Creditors must bear the Chapter 11 costs that helped them unlock the going concern value of their collateral. If the Secured Creditors receive payment in full, they will have paid nothing for these bankruptcy cases—while the costs of these cases will have been forced upon the unsecured creditors, whose recovery, at best, is projected to be very, very small.

Under the Plan, the Secured Creditors are slated to recover significantly more from the Debtors' Chapter 11 process than they would have had they simply been permitted to foreclose. Had the Secured Creditors been given relief from stay at the very outset of these cases and thus been permitted to foreclose upon their collateral, or had they foreclosed prepetition, their recovery would have been materially impaired compared to the payment in full they now expect to receive under the Debtors' Plan. The Secured Creditors are not licensed to operate medical facilities, were not approved to do so by the Attorney General of the State of California, and would have needed to borrow substantial sums of money outside of bankruptcy in order to preserve operations with a third-party operator. Indeed, it is far from clear that, in that scenario, the Secured Creditors would have been able to sustain operations, and if not, they would have been forced to wind-down hospital operations at extraordinary expense. In such a liquidation, the Secured Creditors would bear the costs of closing down the hospitals, and caring for and ultimately moving patients—an extremely costly proposition—in order to obtain their collateral free and clear.

1 These cases—like many others—should not be run exclusively or even primarily for the benefit
2 of secured creditors. *See In re Def. Drug Stores, Inc.*, 145 B.R. 312, 317 (B.A.P. 9th Cir. 1992)
3 (affirming bankruptcy court's order denying "arrangements that convert the bankruptcy process from
4 one designed to benefit all creditors to one designed for the unwarranted benefit of the postpetition
5 lender"); *In re Tenney Vill. Co., Inc.*, 104 B.R. 562, 568 (Bankr. D.N.H. 1989) (declining a debtors'
6 motion to approve a DIP financing agreement that "would pervert the reorganizational process from
7 one designed to accommodate all classes of creditors and equity interests to one specially crafted for
8 the benefit of the Bank"); *see also* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*,
9 47 B.C. L. Rev. 129, 130 (2005) (In modern bankruptcy law, "[t]he preservation of going-concern
10 values and jobs became more important than the enforcement of contractual rights and the liquidation
11 and dismemberment of a debtor's assets to benefit particular creditors.") The Plan primarily benefits
12 the Secured Creditors without justification, to the detriment of unsecured creditors' recovery, and
13 without consideration for the costs of these Chapter 11 Cases.

14 **4) The Plan Cannot Be Confirmed With Its Overbroad Exculpation Provision**

15 The Plan's proposed exculpation of parties other than estate fiduciaries is inappropriate. (Plan
16 § 5.2) Absent consent from the parties whose rights would be affected thereby, a plan cannot grant
17 exculpation to any party other than a debtor and any official committees, whose members and
18 professionals are entitled to qualified immunity under section 1103(c) of the Bankruptcy Code. *See*
19 *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*,
20 584 F.3d 229, 252–53 (5th Cir. 2009) (rejecting exculpation provision in plan except as it applies to
21 the official committee of unsecured creditors and its members); *In re Pilgrim's Pride Corp.*, No. 08-
22 45664, 2010 Bankr. LEXIS 72, *16 (Bankr. N.D. Tex. Jan. 14, 2010) ("[T]he court may not, over
23 objection, approve through confirmation of the [p]lan third-party protections, other than those
24 provided to the [c]ommittees, members of the [c]ommittees, and the [c]ommittee's [p]rofessionals.").
25 Absent such consent, the inclusion of exculpation of non-fiduciaries appears to render the Plan
26 unconfirmable.
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1 For all the foregoing reasons, the Motion must be denied for failure to describe a confirmable
2 Plan.[8]

3 **B. The Disclosure Statement Fails To Provide Adequate Information**

4 The Disclosure Statement cannot be approved because it does not contain "adequate
5 information" as required by section 1125(b) of the Bankruptcy Code.

6 In evaluating whether a disclosure statement contains "adequate information," the Court has
7 substantial discretion. *See Computer Task Group v. Brotby (In re Brotby)*, 303 B.R. 177, 193 (B.A.P.
8 9th Cir. 2003) ("[T]he determination of what is adequate information is subjective and made on a case
9 by case basis. This determination is largely within the discretion of the bankruptcy court.") (quoting
10 *In re Texas Extrusion Corp.*, 844 F.2d 1142, 1157 (5th Cir. 1988)). The Bankruptcy Code defines
11 "adequate information" as information "that would enable . . . a hypothetical investor of the relevant
12 class to make an informed judgment about the plan," and instructs that the Court should "consider the
13 complexity of the case, the benefit of additional information to creditors and other parties in interest,
14 and the cost of providing additional information." 11 U.S.C. § 1125(a)(1); *see also In re Copy Crafters*
15 *Quickprint, Inc.*, 92 B.R. 973, 979 (Bankr. N.D.N.Y. 1988) (courts must apply "a flexible standard
16 that can promote the policy of Chapter 11 towards fair settlement through a negotiation process
17 between informed interested parties"). Although a debtor's "full and fair disclosure" is a guiding
18 principle throughout a bankruptcy case, *see Momentum Mfg. Corp. v. Employee Creditors Comm. (In*
19 *re Momentum Mfg. Corp.)*, 25 F.3d 1132, 1136 (2d Cir. 1994), debtors owe a particular obligation of
20 disclosure to creditors impaired under a proposed plan of reorganization. *See In re Feldman*, 53 B.R.
21 355, 357–58 (Bankr. S.D.N.Y. 1985). Accordingly, it is critical that a disclosure statement provide
22 information sufficient to enable creditors to make an informed decision about whether to accept or
23 reject a proposed chapter 11 plan.

24 Here, the Disclosure Statement omits key information required for creditors to evaluate the
25 Plan. Absent the Debtors' revising the Disclosure Statement to add the following information

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[8] The Committee has other concerns regarding the confirmability of the Plan. It is not clear the Debtors have met their burden of proof to substantively consolidate the Debtors in these Chapter 11 Cases. In addition, it is not clear that unsecured creditors can or should be classified in four distinct classes, separated by settlements that do not yet exist and with a convenience class whose impact on recoveries is unclear.

necessary for the proper evaluation of the merits of the Plan (or revising the Plan as necessary to address its deficiencies), the Disclosure Statement does not satisfy section 1125 of the Bankruptcy Code and, accordingly, cannot be approved. *See, e.g.*, *In re Divine Ripe, LLC*, 554 B.R. 395, 405–13 (Bankr. S.D. Tex. 2016) (rejecting disclosure statement as lacking adequate information regarding, among other things, projections and financial information); *In re Diversified Inv'rs Fund XVII*, 91 B.R. 559, 562 (Bankr. C.D. Cal. 1988) (declining to approve disclosure statement where information in liquidation analysis was inadequate).

1) Inadequate Disclosure With Respect to Proposed Treatment of Secured Creditors

The Secured Creditors do not have "allowed" claims, as discussed above, given the pending adversary actions. The Disclosure Statement fails to describe how a Plan could be confirmed in violation of Section 502 of the Bankruptcy Code which requires adjudication of the validity, priority, and extent of the Secured Creditors' liens before a distribution could be made on account of the secured portion of their claims. In effect, the Disclosure Statement completely ignores the live controversy surrounding the Secured Creditors, the attendant results of any future judgment against the Secured Creditors, and projects recoveries for secured creditors who cannot claim exclusive dominion over post-petition QAF Disbursements, cash collateral, or the going concern premium generated by the Sales in these Chapter 11 Cases.

Furthermore, the Disclosure Statement states that six of the seven classes of secured claims are impaired, but each secured creditor would be paid 100% of their claims on the Effective Date. Why then are the secured creditors designated as impaired? It is not clear from the Disclosure Statement whether Debtors are relying on some form of artificial impairment, or have determined some or all classes of secured creditors are undersecured, or something else. The Disclosure Statement contains no meaningful discussion or description of the secured creditors' impairment and whether each impaired class should be entitled to vote.[9]

[9] Furthermore, if the Committee prevails in its challenge to the validity, priority, and extent of the Secured Creditors' liens, the Secured Creditors may be undersecured. The Secured Creditors would not be entitled to exclusive recovery of proceeds of non-collateral assets, and adequate protection payments of post-petition interest, fees, and costs would only serve to reduce the principal amount of the Secured Creditors' claims.

2) Absence of Information Critical to the Proposed Classification and Treatment of Unsecured Creditors

The Disclosure Statement describes a Plan with four classes of unsecured claims but is missing key information that would support the propriety of separate classification of such unsecured claims. Class 8 (PBGC Claims) and Class 9 (RPHE Claims) assume settlements not yet reached. The convenience class is limited to creditors holding allowed claims not exceeding $100,000, and such creditors would receive a 4% recovery on their claims. The Disclosure Statement is void of information regarding the projected impact of the separate classification of these three classes on the recoveries of other general unsecured claims. It also is not clear from the Disclosure Statement whether (i) the Debtors forecast the same 4% recovery to be paid to the convenience class for all general unsecured creditors or not, or (ii) whether the assets being transferred to the Liquidating Trust, such as the retained causes of action, will yield any meaningful value for unsecured creditors.

Furthermore, the Disclosure Statement fails to disclose or analyze the impact the Committee's pending adversary proceedings against the Secured Creditors may have on recoveries for unsecured creditors if these proceedings confirm the attempted overpayment of Secured Creditors contemplated by the Plan.

3) Failure to Provide a Liquidation Analysis

The Disclosure Statement does not provide a liquidation analysis that would show, among other things, whether each class of impaired creditors would receive or retain property of a value not less than what they would receive in a chapter 7 liquidation.[10] "Case law holds that in order to provide adequate information, the disclosure statement must contain a liquidation analysis which compares the proposed plan of reorganization with a Chapter 7 liquidation." *In re Diversified Inv'rs Fund XVII*, 91 B.R. 559, 561 (Bankr. C.D. Cal. 1988) (citing *In re Metrocraft Pub. Services, Inc.*, 39 B.R. 567 (Bankr. N.D. Georgia 1984); *In re Malek*, 35 B.R. 443 (Bankr. E.D. Mich. 1983); *In re A.C. Williams Co.*, 25 B.R. 173 (Bankr. N.D. Ohio 1982).

The proposed Plan appears to reflect an overpayment to Secured Creditors, leaving less money available to distribute to unsecured creditors. A liquidation analysis should reflect the disparity in

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[10] The Disclosure Statement refers to an "Exhibit A" of a Liquidation Analysis (p. 85), but none is attached.

recoveries between the proposed Plan, which ignores the challenges to the Secured Creditors' liens and would pay the Secured Creditors in full, and a liquidation that would make distributions to the Secured Creditors reflecting only their *allowed* claims, with the remainder to general unsecured creditors. It is not enough to say a liquidation would impose additional administration costs and not take into account the disparate treatment of claims under the proposed Plan.

4) Lack of Disclosure of Individuals, Reserves and Budgets, and Governance for Post-Effective Date Debtors and Liquidating Trust

The Disclosure Statement states that on the Effective Date of the Plan, a Liquidating Trust will be formed and will hold certain causes of action and other Liquidating Trust Assets for the benefit of holders of general unsecured claims. The Disclosure Statement fails to explain why the Debtors will choose the Liquidating Trustee rather than the Committee, which is the fiduciary for general unsecured creditors in these cases. According to the Plan, the only entity whose members are selected by the Committee is the Post-Effective Date Committee, and it is not clear whether the Post-Effective Date Committee has powers beyond consultation and coordination rights over the Liquidating Trustee and Responsible Officer. (*See* Plan § 7.10(c).)

The Disclosure Statement does not identify the individuals that will serve as officers and directors of the Debtor-affiliated entities that will emerge on the Effective Date. These include the three individual directors of the Post-Effective Date Board of Directors, the three members of the Post-Effective Date Committee, the Liquidating Trustee, and the Responsible Officer. Under the definition of "Plan Supplement," the identities of the initial Responsible Officer, Liquidating Trustee, and directors of the Post-Effective Date Board of Directors—all selected by the Debtors—may not be disclosed until just prior to the Effective Date, after the confirmation hearing. The possibility for such a late disclosure would appear to violate section 1129(a)(5)'s confirmation requirement that a plan proponent disclose prior to the confirmation hearing "the identity and affiliations of any individual proposed to serve, after confirmation of the plan, as a director, officer, or voting trustee of the debtor . . . or a successor to the debtor under the plan." 11 U.S.C. § 1129(a)(5)(A)(i). It is critical that creditors voting on the Plan be informed of the people being appointed to oversee the liquidation of

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trust assets, of each individual's affiliations with the Debtors and related parties, and of their qualifications to serve as officers and directors of the Post-Effective Date entities.

Also, the Disclosure Statement does not project or estimate amounts needed to fund reserves for the Post-Effective Date operation and liquidation of the Debtors' estates and responsible parties.

5) Inadequate Information Regarding Destruction and Abandonment of Books and Records

The Plan provides that the Liquidating Trustee and Responsible Officer, as applicable, have authority to abandon or destroy records without notice or court order. (Plan § 7.12.) The Disclosure Statement lacks information regarding what safeguards will be in place to preserve the Debtors' books and records and why the Debtors believe granting these officers unilateral authority to destroy records is appropriate. Furthermore, the Debtors have yet to accommodate the Committee's repeated requests to copy the Debtors' books and records to ensure the Liquidating Trust has sufficient information to prosecute causes of action and review claims.[11]

6) Absence of Additional Critical Information

The following additional items require additional disclosure to enable creditors to evaluate the Plan:

- *Tax Consequences of Plan* (Disclosure Statement, at 69): The Disclosure Statement states that the Post-Effective Date Debtors will retain their tax-exempt status, but if the tax-exempt status were to terminate, the Post-Effective Date Debtors would be subject to tax on their income, which would reduce the amount of distributions payable to the Liquidating Trust. To the extent there is a risk that the Post-Effective Date Debtors would lose their tax-exempt status, the Disclosure Statement should describe the risk factors that might lead to the loss of such status and quantify the potential tax cost of the Sales and other disposition of assets that would result from loss of tax-exempt status.

- *Dissolution of Non-Debtor Affiliates* (Disclosure Statement, at 55; Plan § 5.2): Although the Debtors state that certain non-debtor entities have no material assets or operations, it is far from clear what authority the Court has to order non-debtor entities deemed dissolved under applicable state law as of the Effective Date.

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[11] To be sure, the Committee does not expect a copy of *all* records, such as confidential patient records. However, preservation of books and records such as general ledgers, account statements, and similar information for evaluation of claims and prosecution of causes of action is critical.

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III. CONCLUSION

These cases and the hard work of the Debtors' many doctors, nurses, healthcare workers, and other employees have permitted the Debtors to generate a very substantial going concern premium that the Secured Creditors would not have realized had they simply foreclosed on their collateral. Under the proposed Plan, however, *none* of that premium will be shared with unsecured creditors—even though *all* of the costs of these cases will be borne by the unsecured creditors.

The Debtors' Plan affords the Secured Creditors a 100% recovery—an unwarranted windfall, especially considering the Secured Creditors' lack of perfected security interest in the Debtors' deposit accounts, post-petition QAF Payments, the Debtors' going concern value, the excess value of the MOB assets, and other material assets, such that the Secured Creditors may be undersecured and not entitled to payment in full. Allowing the Secured Creditors to reap the significant benefits of these cases without paying their fair share of the associated costs—let alone before litigation is resolved to determine the allowed amounts of the secured portions their claims—would provide them with an end run around the equitable principles inherent in the Bankruptcy Code. Such an outcome would be neither fair nor warranted by the circumstances.

Based on the foregoing, the Committee respectfully requests the Court deny the Motion in its entirety.

DATED: September 18, 2019

MILBANK LLP

/s/ Mark Shinderman
GREGORY A. BRAY
MARK SHINDERMAN
DANIEL B. DENNY

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

PROOF OF SERVICE OF DOCUMENT

I am over the age of 18 and not a party to this bankruptcy case or adversary proceeding. My business address is:

2029 Century Park E, 33rd Floor, Los Angeles, CA 90067.

A true and correct copy of the foregoing document entitled (*specify*): ***OFFICIAL COMMITTEE OF UNSECURED CREDITORS' OBJECTION TO MOTION OF THE DEBTORS FOR AN ORDER APPROVING PROPOSED DISCLOSURE STATEMENT AND OTHER RELIEF*** will be served or was served **(a)** on the judge in chambers in the form and manner required by LBR 5005-2(d); and **(b)** in the manner stated below:

1. TO BE SERVED BY THE COURT VIA NOTICE OF ELECTRONIC FILING (NEF): Pursuant to controlling General Orders and LBR, the foregoing document will be served by the court via NEF and hyperlink to the document. On (*date*) September 18, 2019, I checked the CM/ECF docket for this bankruptcy case or adversary proceeding and determined that the following persons are on the Electronic Mail Notice List to receive NEF transmission at the email addresses stated below:

☒ Service information continued on attached page

2. SERVED BY UNITED STATES MAIL:
On (*date*) September 18, 2019, I served the following persons and/or entities at the last known addresses in this bankruptcy case or adversary proceeding by placing a true and correct copy thereof in a sealed envelope in the United States mail, first class, postage prepaid, and addressed as follows. Listing the judge here constitutes a declaration that mailing to the judge will be completed no later than 24 hours after the document is filed.

☒ Service information continued on attached page

3. SERVED BY PERSONAL DELIVERY, OVERNIGHT MAIL, FACSIMILE TRANSMISSION OR EMAIL (state method for each person or entity served): Pursuant to F.R.Civ.P. 5 and/or controlling LBR, on (*date*) September 18, 2019, I served the following persons and/or entities by personal delivery, overnight mail service, or (for those who consented in writing to such service method), by facsimile transmission and/or email as follows. Listing the judge here constitutes a declaration that personal delivery on, or overnight mail to, the judge will be completed no later than 24 hours after the document is filed.

☒ Service information continued on attached page

I declare under penalty of perjury under the laws of the United States that the foregoing is true and correct.

September 18, 2019	Ricky Windom	/s/ Ricky Windom
Date	*Printed Name*	*Signature*

SERVICE LIST
(Via NEF)

- **Alexandra Achamallah** aachamallah@milbank.com, rliubicic@milbank.com
- **Melinda Alonzo** ml7829@att.com
- **Robert N Amkraut** ramkraut@foxrothschild.com
- **Kyra E Andrassy** kandrassy@swelawfirm.com, lgarrett@swelawfirm.com;gcruz@swelawfirm.com;jchung@swelawfirm.com
- **Simon Aron** saron@wrslawyers.com
- **Lauren T Attard** lattard@bakerlaw.com, agrosso@bakerlaw.com
- **Allison R Axenrod** allison@claimsrecoveryllc.com
- **Keith Patrick Banner** kbanner@greenbergglusker.com, sharper@greenbergglusker.com;calendar@greenbergglusker.com
- **Cristina E Bautista** cristina.bautista@kattenlaw.com, ecf.lax.docket@kattenlaw.com
- **James Cornell Behrens** jbehrens@milbank.com, gbray@milbank.com;mshinderman@milbank.com;dodonnell@milbank.com;jbrewster@milbank.com;JWeber@milbank.com
- **Ron Bender** rb@lnbyb.com
- **Bruce Bennett** bbennett@jonesday.com
- **Peter J Benvenutti** pbenvenutti@kellerbenvenutti.com, pjbenven74@yahoo.com
- **Michael Jay Berger** michael.berger@bankruptcypower.com, yathida.nipha@bankruptcypower.com;michael.berger@ecf.inforuptcy.com
- **Leslie A Berkoff** lberkoff@moritthock.com, hmay@moritthock.com
- **Steven M Berman** sberman@slk-law.com
- **Alicia K Berry** Alicia.Berry@doj.ca.gov
- **Stephen F Biegenzahn** efile@sfblaw.com
- **Scott E Blakeley** seb@blakeleyllp.com, ecf@blakeleyllp.com
- **Karl E Block** kblock@loeb.com, jvazquez@loeb.com;ladocket@loeb.com;kblock@ecf.courtdrive.com
- **Dustin P Branch** branchd@ballardspahr.com, carolod@ballardspahr.com;hubenb@ballardspahr.com
- **Michael D Breslauer** mbreslauer@swsslaw.com, wyones@swsslaw.com;mbreslauer@ecf.courtdrive.com;wyones@ecf.courtdrive.com
- **Chane Buck** cbuck@jonesday.com
- **Lori A Butler** butler.lori@pbgc.gov, efile@pbgc.gov
- **Howard Camhi** hcamhi@ecjlaw.com, tcastelli@ecjlaw.com;amatsuoka@ecjlaw.com
- **Barry A Chatz** barry.chatz@saul.com, jurate.medziak@saul.com
- **Shirley Cho** scho@pszjlaw.com
- **Shawn M Christianson** cmcintire@buchalter.com, schristianson@buchalter.com
- **Louis J. Cisz** lcisz@nixonpeabody.com, jzic@nixonpeabody.com
- **Leslie A Cohen** leslie@lesliecohenlaw.com, jaime@lesliecohenlaw.com;odalys@lesliecohenlaw.com
- **Kevin Collins** kevin.collins@btlaw.com, Kathleen.lytle@btlaw.com
- **David N Crapo** dcrapo@gibbonslaw.com, elrosen@gibbonslaw.com
- **Mariam Danielyan** md@danielyanlawoffice.com, danielyan.mar@gmail.com
- **Brian L Davidoff** bdavidoff@greenbergglusker.com, calendar@greenbergglusker.com;jking@greenbergglusker.com
- **Aaron Davis** aaron.davis@bryancave.com, kat.flaherty@bryancave.com
- **Anthony Dutra** adutra@hansonbridgett.com
- **Kevin M Eckhardt** kevin.eckhardt@gmail.com, keckhardt@hunton.com
- **Lei Lei Wang Ekvall** lekvall@swelawfirm.com, lgarrett@swelawfirm.com;gcruz@swelawfirm.com;jchung@swelawfirm.com
- **Andy J Epstein** taxcpaesq@gmail.com
- **Christine R Etheridge** christine.etheridge@ikonfin.com
- **M Douglas Flahaut** flahaut.douglas@arentfox.com
- **Michael G Fletcher** mfletcher@frandzel.com, sking@frandzel.com

- **Joseph D Frank** jfrank@fgllp.com, mmatlock@fgllp.com;csmith@fgllp.com;jkleinman@fgllp.com;csucic@fgllp.com
- **William B Freeman** bill.freeman@kattenlaw.com, nicole.jones@kattenlaw.com,ecf.lax.docket@kattenlaw.com
- **Eric J Fromme** efromme@tocounsel.com, lchapman@tocounsel.com;sschuster@tocounsel.com
- **Amir Gamliel** amir-gamliel-9554@ecf.pacerpro.com, cmallahi@perkinscoie.com;DocketLA@perkinscoie.com
- **Jeffrey K Garfinkle** jgarfinkle@buchalter.com, docket@buchalter.com;dcyrankowski@buchalter.com
- **Thomas M Geher** tmg@jmbm.com, bt@jmbm.com;fc3@jmbm.com;tmg@ecf.inforuptcy.com
- **Lawrence B Gill** lgill@nelsonhardiman.com, rrange@nelsonhardiman.com
- **Paul R. Glassman** pglassman@sycr.com
- **Matthew A Gold** courts@argopartners.net
- **Eric D Goldberg** eric.goldberg@dlapiper.com, eric-goldberg-1103@ecf.pacerpro.com
- **Marshall F Goldberg** mgoldberg@glassgoldberg.com, jbailey@glassgoldberg.com
- **David Guess** dguess@bienertkatzman.com, 4579179420@filings.docketbird.com
- **Anna Gumport** agumport@sidley.com
- **Melissa T Harris** harris.melissa@pbgc.gov, efile@pbgc.gov
- **James A Hayes** jhayes@jamesahayesaplc.com
- **Michael S Held** mheld@jw.com
- **Lawrence J Hilton** lhilton@onellp.com, lthomas@onellp.com,info@onellp.com,rgolder@onellp.com,lhyska@onellp.com,nlichtenberger@onellp.com
- **Robert M Hirsh** Robert.Hirsh@arentfox.com
- **Florice Hoffman** fhoffman@socal.rr.com, floricehoffman@gmail.com
- **Lee F Hoffman** leehoffmanjd@gmail.com, lee@fademlaw.com
- **Michael Hogue** hoguem@gtlaw.com, fernandezc@gtlaw.com;SFOLitDock@gtlaw.com
- **Matthew B Holbrook** mholbrook@sheppardmullin.com, mmanns@sheppardmullin.com
- **David I Horowitz** david.horowitz@kirkland.com, keith.catuara@kirkland.com;terry.ellis@kirkland.com;elsa.banuelos@kirkland.com;ivon.granados@kirkland.com
- **Brian D Huben** hubenb@ballardspahr.com, carolod@ballardspahr.com
- **Benjamin Ikuta** bikuta@hml.law, aoremus@hml.law
- **Lawrence A Jacobson** laj@cohenandjacobson.com
- **John Mark Jennings** johnmark.jennings@kutakrock.com, mary.clark@kutakrock.com
- **Monique D Jewett-Brewster** mjb@hopkinscarley.com, eamaro@hopkinscarley.com
- **Crystal Johnson** M46380@ATT.COM
- **Gregory R Jones** gjones@mwe.com, rnhunter@mwe.com
- **Lance N Jurich** ljurich@loeb.com, karnote@loeb.com;ladocket@loeb.com;ljurich@ecf.courtdrive.com
- **Jeff D Kahane** jkahane@duanemorris.com, dmartinez@duanemorris.com
- **Steven J Kahn** skahn@pszyjw.com
- **Cameo M Kaisler** salembier.cameo@pbgc.gov, efile@pbgc.gov
- **Ivan L Kallick** ikallick@manatt.com, ihernandez@manatt.com
- **Ori Katz** okatz@sheppardmullin.com, cshulman@sheppardmullin.com;ezisholtz@sheppardmullin.com;lsegura@sheppardmullin.com
- **Payam Khodadadi** pkhodadadi@mcguirewoods.com, dkiker@mcguirewoods.com
- **Christian T Kim** ckim@dumas-law.com, ckim@ecf.inforuptcy.com
- **Jane Kim** jkim@kellerbenvenutti.com
- **Monica Y Kim** myk@lnbrb.com, myk@ecf.inforuptcy.com
- **Gary E Klausner** gek@lnbyb.com
- **Nicholas A Koffroth** nick.koffroth@dentons.com, chris.omeara@dentons.com
- **Joseph A Kohanski** jkohanski@bushgottlieb.com, kprestegard@bushgottlieb.com
- **Darryl S Laddin** bkrfilings@agg.com
- **Robert S Lampl** advocate45@aol.com, rlisarobinsonr@aol.com
- **Richard A Lapping** richard@lappinglegal.com
- **Paul J Laurin** plaurin@btlaw.com, slmoore@btlaw.com;jboustani@btlaw.com

- **Nathaniel M Leeds** nathaniel@mitchelllawsf.com, sam@mitchelllawsf.com
- **David E Lemke** david.lemke@wallerlaw.com, chris.cronk@wallerlaw.com;Melissa.jones@wallerlaw.com;cathy.thomas@wallerlaw.com
- **Elan S Levey** elan.levey@usdoj.gov, louisa.lin@usdoj.gov
- **Tracy L Mainguy** bankruptcycourtnotices@unioncounsel.net, tmainguy@unioncounsel.net
- **Samuel R Maizel** samuel.maizel@dentons.com, alicia.aguilar@dentons.com;docket.general.lit.LOS@dentons.com;tania.moyron@dentons.com;kathryn.howard@dentons.com;joan.mack@dentons.com;derry.kalve@dentons.com
- **Alvin Mar** alvin.mar@usdoj.gov
- **Craig G Margulies** Craig@MarguliesFaithlaw.com, Victoria@MarguliesFaithlaw.com;David@MarguliesFaithLaw.com;Helen@MarguliesFaithlaw.com;Dana@marguliesfaithlaw.com
- **Hutchison B Meltzer** hutchison.meltzer@doj.ca.gov, Alicia.Berry@doj.ca.gov
- **Christopher Minier** becky@ringstadlaw.com, arlene@ringstadlaw.com
- **John A Moe** john.moe@dentons.com, derry.kalve@dentons.com
- **Susan I Montgomery** susan@simontgomerylaw.com, assistant@simontgomerylaw.com;simontgomerylawecf.com@gmail.com;montgomerysr71631@notify.bestcase.com
- **Monserrat Morales** Monsi@MarguliesFaithLaw.com, Victoria@MarguliesFaithLaw.com;David@MarguliesFaithLaw.com;Helen@marguliesfaithlaw.com;Dana@marguliesfaithlaw.com
- **Kevin H Morse** kmorse@clarkhill.com, blambert@clarkhill.com
- **Marianne S Mortimer** mmartin@jmbm.com
- **Tania M Moyron** tania.moyron@dentons.com, chris.omeara@dentons.com;nick.koffroth@dentons.com
- **Alan I Nahmias** anahmias@mbnlawyers.com, jdale@mbnlawyers.com
- **Akop J Nalbandyan** jnalbandyan@LNtriallawyers.com, cbautista@LNtriallawyers.com
- **Jennifer L Nassiri** jennifernassiri@quinnemanuel.com
- **Charles E Nelson** nelsonc@ballardspahr.com, wassweilerw@ballardspahr.com
- **Sheila Gropper Nelson** shedoesbklaw@aol.com
- **Mark A Neubauer** mneubauer@carltonfields.com, mlrodriguez@carltonfields.com;smcloughlin@carltonfields.com;schau@carltonfields.com;NDunn@carltonfields.com;ecfla@carltonfields.com
- **Nancy Newman** nnewman@hansonbridgett.com, ajackson@hansonbridgett.com;calendarclerk@hansonbridgett.com
- **Bryan L Ngo** bngo@fortislaw.com, BNgo@bluecapitallaw.com;SPicariello@fortislaw.com;JNguyen@fortislaw.com;JNguyen@bluecapitallaw.com
- **Abigail V O'Brient** avobrient@mintz.com, docketing@mintz.com;DEHashimoto@mintz.com;nleali@mintz.com;ABLevin@mintz.com;GJLeon@mintz.com
- **John R OKeefe** jokeefe@metzlewis.com, slohr@metzlewis.com
- **Scott H Olson** solson@vedderprice.com, jcano@vedderprice.com,jparker@vedderprice.com;scott-olson-2161@ecf.pacerpro.com,ecfsfdocket@vedderprice.com
- **Giovanni Orantes** go@gobklaw.com, gorantes@orantes-law.com,cmh@gobklaw.com,gobklaw@gmail.com,go@ecf.inforuptcy.com;orantesgr89122@notify.bestcase.com
- **Keith C Owens** kowens@venable.com, khoang@venable.com
- **R Gibson Pagter** gibson@ppilawyers.com, ecf@ppilawyers.com;pagterrr51779@notify.bestcase.com
- **Paul J Pascuzzi** ppascuzzi@ffwplaw.com, lnlasley@ffwplaw.com
- **Lisa M Peters** lisa.peters@kutakrock.com, marybeth.brukner@kutakrock.com
- **Christopher J Petersen** cjpetersen@blankrome.com, gsolis@blankrome.com
- **Mark D Plevin** mplevin@crowell.com, cromo@crowell.com
- **Steven G. Polard** spolard@ch-law.com, calendar-lao@rmkb.com;melissa.tamura@rmkb.com;anthony.arriola@rmkb.com
- **David M Powlen** david.powlen@btlaw.com, pgroff@btlaw.com

- **Christopher E Prince** cprince@lesnickprince.com, jmack@lesnickprince.com;erivas@lesnickprince.com;cprince@ecf.courtdrive.com
- **Lori L Purkey** bareham@purkeyandassociates.com
- **William M Rathbone** wrathbone@grsm.com, jmydlandevans@grsm.com;sdurazo@grsm.com
- **Jason M Reed** Jason.Reed@Maslon.com
- **Michael B Reynolds** mreynolds@swlaw.com, kcollins@swlaw.com
- **J. Alexandra Rhim** arhim@hrhlaw.com
- **Emily P Rich** erich@unioncounsel.net, bankruptcycourtnotices@unioncounsel.net
- **Robert A Rich** , candonian@huntonak.com
- **Lesley A Riis** lriis@dpmclaw.com
- **Debra Riley** driley@allenmatkins.com
- **Julie H Rome-Banks** julie@bindermalter.com
- **Mary H Rose** mrose@buchalter.com
- **Megan A Rowe** mrowe@dsrhealthlaw.com, lwestoby@dsrhealthlaw.com
- **Nathan A Schultz** nschultz@goodwinlaw.com
- **William Schumacher** wschumacher@jonesday.com
- **Mark A Serlin** ms@swllplaw.com, mor@swllplaw.com
- **Seth B Shapiro** seth.shapiro@usdoj.gov
- **David B Shemano** dshemano@shemanolaw.com
- **Joseph Shickich** jshickich@riddellwilliams.com
- **Mark Shinderman** mshinderman@milbank.com, dmuhrez@milbank.com;dlbatie@milbank.com
- **Rosa A Shirley** rshirley@nelsonhardiman.com, ksherry@nelsonhardiman.com;lgill@nelsonhardiman.com;rrange@nelsonhardiman.com
- **Kyrsten Skogstad** kskogstad@calnurses.org, rcraven@calnurses.org
- **Michael St James** ecf@stjames-law.com
- **Andrew Still** astill@swlaw.com, kcollins@swlaw.com
- **Jason D Strabo** jstrabo@mwe.com, cfuraha@mwe.com
- **Sabrina L Streusand** Streusand@slollp.com
- **Ralph J Swanson** ralph.swanson@berliner.com, sabina.hall@berliner.com
- **Gary F Torrell** gtorrell@health-law.com
- **United States Trustee (LA)** ustpregion16.la.ecf@usdoj.gov
- **Cecelia Valentine** cecelia.valentine@nlrb.gov
- **Matthew S Walker** matthew.walker@pillsburylaw.com, renee.evans@pillsburylaw.com,docket@pillsburylaw.com
- **Jason Wallach** jwallach@ghplaw.com, g33404@notify.cincompass.com
- **Kenneth K Wang** kenneth.wang@doj.ca.gov, Jennifer.Kim@doj.ca.gov;Stacy.McKellar@doj.ca.gov;yesenia.caro@doj.ca.gov
- **Phillip K Wang** phillip.wang@rimonlaw.com, david.kline@rimonlaw.com
- **Adam G Wentland** awentland@tocounsel.com, lkwon@tocounsel.com
- **Latonia Williams** lwilliams@goodwin.com, bankruptcy@goodwin.com
- **Michael S Winsten** mike@winsten.com
- **Jeffrey C Wisler** jwisler@connollygallagher.com, dperkins@connollygallagher.com
- **Neal L Wolf** nwolf@hansonbridgett.com, calendarclerk@hansonbridgett.com,lchappell@hansonbridgett.com
- **Hatty K Yip** hatty.yip@usdoj.gov
- **Andrew J Ziaja** aziaja@leonardcarder.com, sgroff@leonardcarder.com;msimons@leonardcarder.com;lbadar@leonardcarder.com
- **Rose Zimmerman** rzimmerman@dalycity.org

SERVICE LIST
(Via First Class Mail)

Verity Health System of California, Inc.
2040 E. Mariposa Avenue
El Segundo, CA 90245

Samuel R. Maizel
Dentons US LLP
601 South Figueroa Street
Suite 2500
Los Angeles, CA 90017

SERVICE LIST
(Via Personal Delivery)

The Honorable Ernest M. Robles
United States Bankruptcy Court
Central District of California
Edward R. Roybal Federal Building and Courthouse
255 E. Temple Street, Suite 1560/Courtroom 1568
Los Angeles, CA 90012-3300

SERVICE LIST
(Via Email)

Attorneys for Chapter 11 Debtors and Debtors in Possession
Samuel R. Maizel – samuel.maizel@dentons.com
John A. Moe, II – john.moe@dentons.com
Tania M. Moyron – tania.moyron@dentons.com
Nick Koffroth – nick.koffroth@dentons.com