

**IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA**

SECRETARY OF THE UNITED STATES	:	
DEPARTMENT OF HEALTH AND HUMAN	:	
SERVICES	:	
	:	NO. 02-CA-737
Appellant	:	
	:	
v.	:	
	:	
22 ACQUISITION CORP.	:	
	:	
Appellee.	:	

MEMORANDUM and ORDER

YOHN, J.

MAY _____, 2002

The Secretary of the United States Department of Health and Human Services (the “Secretary”) appeals from the bankruptcy court’s final order dated January 25, 2002 (effective January 3, 2002), authorizing secured post-petition financing on a super priority basis pursuant to 11 U.S.C. §§ 105, 363, 364, and 507(b) (the “DIP order”). In particular, the Secretary appeals the portion of this order that provides that the post-petition loan is to be repaid in full prior to the payment of any other claims except the ordinary and necessary operating expenses and the administrative expenses of the debtor. The Secretary maintains that this provision creates an impermissible priority in the debtor’s unsecured administrative expenses over the Secretary’s secured setoff rights.

After reviewing this appeal, I find that although the plain language of the written DIP order allows the payment of all administrative expenses before the DIP loan is fully repaid,

thereby subordinating the Secretary's setoff rights, this may not have been the intended consequence of the bankruptcy court's DIP order as stated verbally by the court during the January 3, 2002 hearing. Rather, the bankruptcy court stated that it intended to consider on a case-by-case basis whether to allow the payment of administrative expenses while the DIP loan was outstanding. As a result, I will remand this action to the bankruptcy court for clarification so that it may consider whether it desires to leave this language as it exists or modify the language of the DIP order to reflect its stated intention regarding the payment of administrative expenses prior to the full repayment of the DIP loan only after individual review and court approval.

BACKGROUND

The debtor, 22 Acquisition Corporation, a Medicare-reimbursed chain of nursing homes, filed for chapter 11 bankruptcy on November 28, 2001. At this time, the debtor also filed a motion to obtain debtor in possession post-petition financing ("DIP financing"). At a hearing on November 30, 2001, the bankruptcy court granted the motion for DIP financing and gave the debtor's lender a super priority lien on the debtor's assets. 02-737 Record, Doc. 6 at 92. The bankruptcy court authorized the immediate transfer of the money obtained through the DIP financing ("DIP loan") to the debtor. Id. at 92-94 The Secretary immediately sought a stay of the order, but this request was denied.¹ Id. at 95-97.

¹ The bankruptcy code prevents appeals of orders granting super priority liens unless the order granting the lien is stayed prior to the transfer of the loan funds. 11 U.S.C. § 364(e). Thus, the combined effect of the bankruptcy court's authorization for the immediate transfer of the DIP loan funds and denial of the Secretary's request for a stay was to render the DIP order unappealable. However, because the Secretary is only challenging a single sentence of the DIP order in this appeal and not the validity of the underlying DIP loan itself, section 364(e) does not bar the court from considering this appeal.

The Secretary has asserted setoff rights against the debtor for debts prior to the bankruptcy filing, maintaining that the debtor was overpaid for its medicare-reimbursed services in an amount in excess of the debtor's claim against the Secretary, and that as a result, the debtor owed a debt to the Secretary, which is a secured claim under the bankruptcy code to the extent of the setoff.² However, because the DIP loan was given super priority, the Secretary cannot be paid his setoff claim until the DIP loan is repaid in full. It is not the super priority of the DIP loan that the Secretary contests in this appeal. Rather, the Secretary contests the provision of the DIP order that exempts administrative expense claims from the super priority status of the DIP loan, and which therefore, in effect, subordinates the Secretary's secured setoff claim to any unsecured administrative expense claims.

On January 3, 2002, the bankruptcy court held a hearing to consider the language of the

² The Medicare Act establishes a federally funded subsidized program that reimburses for medical services provided to qualified elderly and disabled persons. 42 U.S.C. § 1395 *et seq.* Under the reimbursement scheme set up by the Medicare Act, Medicare providers are to be paid periodically, on an interim basis, before an audit is conducted to determine the precise amount of reimbursement due to the provider. 42 U.S.C. § 1395g(a). After the Medicare provider has submitted its fiscal year cost report, the fiscal intermediary determines the exact amount of reimbursement to which the provider is entitled and this amount is adjusted to take into account any earlier overpayments. 42 U.S.C. §§ 1395g(a), 1395x(v)(1)(A)(ii), 42 C.F.R. § 413.60.

The bankruptcy code defines setoff as the "right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the [bankruptcy] against a claim of such creditor against the debtor that arose before the [bankruptcy]." 11 U.S.C. § 553(a). Although the Secretary maintains that it has such a setoff right here, the exact origin of the Secretary's claimed right to setoff in this case is unclear from the memoranda presently before the court. However, upon reviewing the transcript of the November 30, 2001 bankruptcy court hearing, it appears that the Secretary asserts that he has a claim against the debtor for approximately three million dollars in medicare overpayments and that the debtor asserts that it is owed approximately one million dollars from the Secretary in underpayments. Because setoff rights are secured claims to the extent of the amount subject to setoff, assuming that these numbers are correct, an issue which is hotly contested by both the Secretary and the debtor, the Secretary would have a secured setoff claim of one million dollars. 11 U.S.C. § 506(a). Perhaps the facts concerning the claimed setoff are clearer now than they were in November and this can be clarified as well on remand.

final order authorizing the DIP loan. At this hearing, the Secretary specifically objected to the following language of the proposed DIP order: “unless otherwise ordered by the Court, the DIP Loan will be repaid in full prior to payment of any other claims in the case besides ordinary and necessary operating expenses and administrative expenses of the Debtor.”³ The Secretary argued that by allowing the payment of the debtor’s administrative expense claims prior to the full payment of the DIP loan, this provision impermissibly subordinated the Secretary’s secured setoff claim to unsecured claims for administrative expenses. 02-737 Record, Doc. 8 at 5-6. Over the Secretary’s objection, the bankruptcy court allowed this disputed language to be included in the final DIP order, stating that this provision was not meant to be an unqualified approval for the payment of administrative expenses prior to the repayment of the DIP loan. Instead, the bankruptcy court stated that it simply wished to afford those with administrative claims the opportunity to request the payment of their claims prior to the full payment of the DIP loan. Id at 17-18.

The written DIP financing order was inadvertently not signed by the bankruptcy judge until January 25, 2002. Upon signing the order, the bankruptcy judge indicated that the order was effective as of January 3, 2002, the date it was announced. The DIP order was entered on the docket on February 6, 2002.

On January 14, 2002, the Secretary filed this appeal, requesting that the court modify the

³ It appears that the clerk of the bankruptcy court erroneously included the final order authorizing debtor’s limited use of cash collateral in the record on appeal, instead of the final DIP order that is actually being appealed here. However, because the Secretary properly identified the DIP order in his designation of items to be included in the record on appeal, I find that the DIP order, which is attached to the Secretary’s appeal brief as Exhibit A, is part of the record on appeal, even though it is not included in the binder compiled by the bankruptcy clerk.

DIP order to avoid the subordination of the Secretary's setoff rights to the payment of administrative expense claims.⁴⁵

STANDARD OF REVIEW

The district court, sitting as an appellate tribunal, applies a clearly erroneous standard to review the bankruptcy court's factual findings and a de novo standard to review its conclusions of law. *In re Siciliano*, 13 F.3d 748, 750 (3d Cir. 1994). A finding of fact is clearly erroneous if a reviewing court has a "definite and firm conviction that a mistake has been committed." *Anderson v. Bessemer City*, 470 U.S. 564, 573 (1985). The factual determination of the bankruptcy court will be accepted unless that determination is either "completely devoid of minimum evidentiary support" or "bears no rational relationship to the supportive evidentiary data." *Hoots v. Pennsylvania*, 703 F.2d 722, 725 (3d Cir. 1983). Mixed questions of fact and law require a mixed standard of review, under which the court reviews findings of historical or narrative fact for clear error but exercises plenary review over the bankruptcy court's "choice and interpretation of legal precepts and its application of those precepts to the historical facts."

⁴ A notice of appeal filed after the announcement of an order but before entry of the written order on the docket is treated as having been filed after the entry and on the date thereof. Fed. R. Bankr. P. 8002(a). Thus, this appeal, which was filed before the DIP order was signed and docketed but after the DIP order was announced from the bench, is timely and not premature.

⁵ The debtor maintains that the Secretary filed a second appeal of the DIP order on February 20, 2002 and that this appeal should be consolidated with the current appeal since the parties and the issues presented are identical. However, to the court's knowledge, the Secretary's February 2002 appeal is not identical to the current appeal. The February appeal challenged the January 18, 2002 order of the bankruptcy court appointing ZA as the debtor's consultant on the basis that the court did not make a finding of ZA's impartiality prior to authorizing its employment.

Mellon Bank N.A. v. Metro Communications, Inc., 945 F.2d 635, 642 (3d Cir. 1991).

DISCUSSION

In bankruptcy, setoff claims are given a secured status and a permissible preference over unsecured claims. 11 U.S.C. § 506(a)⁶; *In re Metropolitan Hosp.*, 131 B.R. 283, 289 (E.D. Pa. 1991). The Secretary maintains that he has a secured setoff claim here, and it is the priority of this secured claim that the Secretary's current appeal seeks to protect. In particular, the Secretary appeals the portion of the DIP order, which provides "unless otherwise ordered by the Court, the DIP Loan will be repaid in full prior to payment of any other claims in the case besides ordinary and necessary operating expenses and administrative expenses of the debtor."

Plainly, this language exempts administrative expenses, but not the exercise of setoff rights, from the requirement that the DIP loan be paid off before other claims are paid, and in effect, the provision causes a potential subordination of the Secretary's claimed setoff rights to the payment of administrative claims. However, upon reviewing the transcript of the bankruptcy court's January 3, 2002 hearing, it is apparent that this was not the effect that the bankruptcy court intended at that time for the DIP order. At this hearing, the bankruptcy court explained that the disputed provision of the DIP order was not intended to provide a blanket authorization for the payment of administrative expenses prior to the retirement of the DIP loan, but that it was only intended to provide claimants with the opportunity to ask for the payment of their administrative claims before the DIP loan expired. The bankruptcy court did not intend to

⁶ Section 506(a) provides that "[a]n allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff."

globally authorize the payment of administrative expense claims; but rather, to consider on a case-by-case basis whether to allow each claim. As such, by providing a blanket authorization for the payment of administrative expenses prior to the full repayment of the DIP loan, the written DIP order does not accurately reflect the stated intentions of the bankruptcy court. Accordingly, I will remand this matter to the bankruptcy court so that it may consider whether it desires to modify the DIP order to more accurately reflect its stated intention to require a case-specific determination of whether to allow payment of an administrative expense claim while the DIP loan remained outstanding.⁷

CONCLUSION

Because the written language of the bankruptcy court's DIP order does not reflect the verbally stated intention of the bankruptcy court when entering the DIP order, I will remand this matter to the bankruptcy court for clarification so that it may consider whether it desires to modify the DIP order.

An appropriate order follows.

⁷ As any future appeal of this matter will likely challenge the bankruptcy court's authorization of a specific request for the payment of an administrative expense, at the time that such an appeal is brought, the court will be able to consider on a more concrete basis the issue of whether by allowing the payment of an administrative expense, the bankruptcy court contravened the priority order of the bankruptcy code and impermissibly subordinated the Secretary's setoff rights. Given that the \$500,000 DIP loan is being paid off at a rate of between \$26,000 and \$50,000 a month, it is possible that the DIP loan may be fully repaid before the payment of a specific administrative claim is challenged on appeal, thereby making such an appeal moot.

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ORDER

And now this _____ day of May, 2002, after consideration of the Appeal and brief of the Secretary of the United States Department of Health and Human Services; 22 Acquisition Corporation's opposition; and the Secretary's reply; it is hereby ORDERED that this matter is REMANDED to the bankruptcy court for consideration of a modification of its order dated January 25, 2002 for the reasons set forth in this opinion.

William H. Yohn, Jr., Judge