

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE:	§	
	§	
UNIVERSITY GENERAL HEALTH	§	CASE NO. 15-31086
SYSTEM, INC., <i>et al.</i> ,	§	
	§	
DEBTORS.	§	CHAPTER 11

**THE TEXAS HEALTH AND HUMAN SERVICES COMMISSION’S
AND THE TEXAS DEPARTMENT OF STATE HEALTH SERVICES’S
SUPPLEMENTAL LIMITED OBJECTION TO DEBTOR’S EMERGENCY MOTION
FOR INTERIM AND FINAL ORDERS (I) AUTHORIZING SECURED
POST-PETITION FINANCING ON A SUPER PRIORITY BASIS PURSUANT
TO 11 U.S.C. §§ 363, 364 AND 507(b); (II) GRANTING RELIEF FROM THE
AUTOMATIC STAY PURSUANT TO 11 U.S.C. § 362; (III) GRANTING
RELATED RELIEF; AND (IV) SCHEDULING A FINAL HEARING
PURSUANT TO BANKRUPTCY RULE 4001
(Relates to Dkt. Nos. 31, 48 and 57)**

TO THE HONORABLE LETITIA Z. PAUL,
UNITED STATES BANKRUPTCY JUDGE:

Comes now the Texas Health and Human Services Commission (“HHSC”) and Texas Department of State Health Services (“DSHS” and together with HHSC, the “State”) through the Texas Attorney General’s Office and respectfully file this Supplemental Limited Objection to Debtors’ Emergency Motion for Interim and Final Orders (i) Authorizing Secured Post-Petition Financing on a Super Priority Basis Pursuant to 11 U.S.C. §§ 363, 364, and 507(b); (ii) Granting Relief from the Automatic Stay Pursuant to 11 U.S.C. § 362; (iii) Granting Related Relief; and (iv) Scheduling a Final Hearing Pursuant to Bankruptcy Rule 4001 (Docket No. 31) (the “Motion”). In support thereof the State would respectfully show as follows:

I. Background Facts

1. On February 27, 2015 (the “Petition Date”), the debtors and debtors in possession in the above captioned cases (collectively, the “Debtors”) each commenced a case by filing a petition for relief under chapter 11 of the United States Bankruptcy Code.

2. The Debtors continue to manage and operate their businesses as debtors in possession pursuant to Bankruptcy Code sections 1107 and 1108.

3. On March 11, 2015, the Office of the United States Trustee filed its Notice of Appointment of Joint Official Committee of Unsecured Creditors (Dkt. No. 92).

4. Prior to that date, on March 2, 2015, the Debtors filed the Motion, which seeks authority on an interim and final basis for a debtor-in-possession secured financing facility (“Post-Petition Financing”) to provide funding for the operating expenses and working capital needs of the Debtors. *See* Motion, ¶ 1. On March 4, 2014, the Court held a hearing on the Motion and entered an order granting the Motion on an interim basis (Dkt. No. 57). The Court has set a final hearing on the Motion on March 30, 2015 at 1:00 p.m.

5. On March 3, 2015, the State filed a limited objection (the “Limited Objection”) (Dkt. No. 48) to the Motion and relief sought therein to the extent that it (1) seeks to cut off HHSC’s right to recoupment with respect to Medicaid overpayments, and (2) fails to include a carve-out for costs associated with maintenance and disposal of patient medical records in accordance with applicable nonbankruptcy law or the alternate provisions contained in 11 U.S.C. § 351. A true and correct copy of the State’s limited objection is attached hereto as Exhibit “A.” Further, the State reserved its right to object to the Motion seeking an order on a final basis.¹

¹ As before, counsel for HHSC and DSHS hopes the parties can resolve the matters raised herein and submit an agreed order. However, to date an agreement has not been reached.

6. The State reasserts its prior objections, and for the reasons set forth in its initial limited objection and also for the reasons set forth below, respectfully requests that any final debtor-in-possession financing order make clear that nothing affects the State's right to recoup Medicaid overpayments; and that the definition of "Carve-Out" in any final order be amended to include costs incurred by any subsequent trustee in closing the hospital as contemplated by 11 U.S.C. § 503(b)(8).

II. The State's Supplemental Limited Objection to the Debtors' Motion

A. The Debtors' Motion and Proposed Final Order Impermissibly Seeks to Cut Off HHSC's Recoupment Rights.

7. The Debtors' proposed Final Order provides, in part, that "MidCap's first priority Lien in pre-petition and post-petition Accounts of the Debtors (and proceeds therefrom) will be senior to and prime any valid lien (if any) asserted by any Governmental Authority or any other creditor with respect to the Accounts of the Debtors", and that "MidCap's first priority Lien on the Debtors' Accounts (and proceeds therefrom) shall be senior to any right of a holder of a claim, including without limitation, any mortgagee, Governmental Authority or landlord, that arose, or is deemed to arise, prior to the Filing Date, of any right of set off, tax lien, tax levy, or to otherwise assert a charge against any such Accounts (except only with respect to any recoupment rights as set forth in Paragraph ____ of this Final Order)." *See* Proposed Order at ¶ 9. The Proposed Order then defines "Governmental Authority" to *specifically* include "the federal and state agencies and their intermediaries administering the Medicare and Medicaid programs with which the Debtors deal." *Id.* While it is the State's position that it does not have a "lien" on Medicaid overpayments in the traditional sense, since such overpayments are property of the State rather than the bankruptcy estate (*see, e.g., Aetna U.S. Healthcare, Inc. v. Madigan et al. (In re Madigan)*, 270

B.R. 749, 754 (B.A.P. 9th Cir. 2001)), the State objects to any efforts to impair, modify or in any way limit its ability to effectuate Medicaid recoupments².

8. In addition, paragraph 11 of the proposed final order provides, in pertinent part:

Except as expressly provided in this paragraph, no Person will be permitted to surcharge the Collateral under Bankruptcy Code §506(c) or to obtain a lien with respect to the Collateral which is equal or senior to the Liens of MidCap on the Collateral (other than with respect to the Prepetition Senior Liens as stated herein). Except as expressly provided in this paragraph, the prohibition on surcharging or priming of the liens of MidCap on the Collateral will survive the termination of the New Loan Agreement such that no Person, including but not limited to Governmental Authorities, will be permitted to obtain a lien (through any means, including setoff) which is equal or senior to the liens of MidCap on the Collateral except only that Governmental Authorities will retain their right (if any) to recoup medical provider reimbursement over payments or other claims (the "Overpayments") from Accounts so long as the Overpayments arise under the same provider agreement or comparable program as the Accounts from which the Governmental Authority seeks recoupment.

The problem with these provisions is twofold: first, this plainly cuts off the right to surcharge the Collateral (as defined in the Motion), which the Court did not approve in the interim debtor-in-possession financing order. The State agrees with the Court that it is inappropriate to preemptively cut off such rights as to third parties at the relative infancy of this case. Should the case convert to a Chapter 7, the Trustee will be saddled with closure costs (also addressed below), including costs associated with the disposition of pharmaceuticals and medical pathology waste. Such medical waste constitutes hazardous materials that is subject to regulation by the Texas Commission on Environmental Quality. It is the State's position that the presence of hazardous

² The Fifth Circuit has explained that "[r]ecoupment allows a defendant to reduce the amount of a plaintiff's claim by asserting a claim against the plaintiff which arose out of the same transaction to arrive at a just and proper liability on the plaintiff's claim." *Holford v. Powers (Matter of Holford)*, 896 F.2d 176 (5th Cir. 1990). In the bankruptcy context, the ability of a creditor to recoup against a debtor crosses over the petition date as it "allows reduction of a prepetition claim against the debtor by application of the claim to reduce a post-petition obligation to the debtor." *Sacramento Mun. Util. Dist. v. Mirant Ams. Energy Mktg., LP, (In re Mirant Corp.)*, 318 B.R. 377, 381 (Bankr. N.D. Tex. 2004) (citing *Kosadnar v. Metropolitan Life Ins. Co. (Matter of Kosadnar)*, 157 F.3d 1011, 1014 (5th Cir.1998)).

material in the form of medical waste would prevent the abandonment of such property pursuant to *Midlantic Nat'l Bank v. New Jersey Dept. of Env'tl. Protection*, 474 U.S. 494 (1986)³ and its progeny. Because the Court at a later date could deem that it is in fact appropriate to surcharge the Collateral for these or other costs incurred by a subsequently-appointed Trustee, the State objects to the waiver or elimination of parties' rights to seek remedies pursuant to section 506(c) of the Bankruptcy Code.

9. Second, there is no authority for the proposition that Medicaid recoupment rights can be primed by liens granted to a debtor-in-possession lender. While the language above mentions the retention of the right to recoup, the State does not believe that the recitation of "so long as the Overpayments arise under the same provider agreement or comparable program as the Accounts from which the Governmental Authority seeks recoupment" is an accurate reflection of the law regarding recoupment of such overpayments. *See, e.g., In re District Memorial Hosp. of Southwestern N.C., Inc.*, 297 B.R. 451 (Bankr. W.D.N.C. 2002) (holding that distinctive Medicare and Medicaid systems of estimated payments and later adjustments qualified as single "transaction," for recoupment purposes). Further, because claims or overpayments subject to recoupment are not property of the estate, they cannot fall within the definition of "Accounts" in the proposed credit agreement.

³ In *Midlantic*, the court found "that a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards." *Midlantic*, 494 U.S. at 507.

10. For these reasons, the State believes that any final order should include the language regarding Medicaid recoupments contained in its Limited Objection and as set forth below to make this proposition absolutely clear. The proposed final order, as currently drafted, appears to attempt to curtail such rights. Accordingly, the State objects to the entry of any final order that affects such recoupment rights.

B. Any Final Order Authorizing Post-Petition Financing Should Contain a Carve-Out of Funds for the Cost of Closing a Health Care Business as Contemplated by 11 U.S.C. § 503(b)(8).

11. The proposed final order circulated by the Debtors provides for a carve-out from the proposed liens of \$250,000.00 for Professional Fees, but fails to provide for costs associated with closure of the Debtors' "health care business," which constitute an administrative expense claim pursuant to 11 U.S.C. § 503(b)(8). Such costs include, but are not limited to, costs associated with the disposition of patient records and the transfer of patients to another health care business.

12. As noted in the State's Limited Objection, the Debtors as debtors-in-possession are required by statute to operate its business in compliance with applicable state law. Federal law is clear on this point. 28 U.S.C. § 959(b) provides, in pertinent part, that "a trustee . . . (or) a debtor in possession shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated. . . ."

13. Without a lien carve-out for closure costs, there will in all likelihood be insufficient unencumbered funds for the estate to maintain its obligations under state law in the event the case converts to Chapter 7 and a trustee is saddled with the burden of closing the Debtors' facilities, including the maintenance of patient records in accordance with applicable law. DSHS respectfully contends that the Carve-Out (as defined in the proposed final order) should be amended to include sufficient funds to provide for the costs of closure of the Debtors' businesses in accordance with

section 503(b)(8) of the Code. If the Debtor successfully reorganizes, or ends up in a sale scenario and the buyer takes possession of the patient records, the issues related to closure of the Debtors' health care business will be moot.

III. Relief Requested

14. Based on the foregoing, HHSC respectfully requests that the Court include the following proposed language in any final postpetition financing or cash collateral order to preserve such recoupment rights:

Notwithstanding anything contained in the Motion or this Order to the contrary, nothing herein shall affect the rights of any Governmental Unit, including but not limited to the Texas Health and Human Services Commission, from exercising its rights of recoupment, but the Debtor In Possession or any Trustee subsequently appointed shall retain its right to exhaust administrative remedies to contest the dollar amount of any recoupment(s) effectuated.

15. In addition, DSHS respectfully requests that the Court include the following proposed language in the final postpetition financing order to provide an appropriate carve-out for costs associated with the closure of the Debtors' facilities in accordance with 11 U.S.C. § 503(b)(8):

Notwithstanding any other provision of this Order or the underlying Motion for Final Order to the contrary, all liens on and security interests in the Cash Collateral recognized by or granted pursuant to this Order, as applicable, and all super priority administrative claims granted pursuant to this Order, shall be subordinate to any fees and expenses associated with the closure of the Debtors' health care business as set forth in 11 U.S.C. § 503(b)(8). Such fees and expenses associated with this carve-out shall constitute an allowed administrative expense claim or claims pursuant to 11 U.S.C. § 503(b).

WHEREFORE, the Texas Health and Human Services Commission and the Texas Department of State Health Services respectfully object to the entry of a final order on cash collateral and/or postpetition financing that does not adequately preserve the State's Medicaid recoupment rights or that fails to fund the costs associated with the closure of the Debtors' health care business.

Respectfully submitted,

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ATTORNEYS FOR THE TEXAS HEALTH AND HUMAN
SERVICES COMMISSION AND THE TEXAS
DEPARTMENT OF STATE HEALTH SERVICES

CERTIFICATE OF SERVICE

I certify that a true and correct copy of the foregoing has been served via the Court's Electronic Filing System on all parties requesting notice in this proceeding and that copies were mailed to the counsel and parties listed below, via first class U.S. Mail, postage prepaid on March 24, 2015.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE: §
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UNIVERSITY GENERAL HEALTH § CASE NO. 15-31086
SYSTEM, INC., *et al.*, §
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DEBTORS. § CHAPTER 11

**THE TEXAS HEALTH AND HUMAN SERVICES COMMISSION’S
AND THE TEXAS DEPARTMENT OF STATE HEALTH SERVICES’S
LIMITED OBJECTION TO DEBTOR’S EMERGENCY MOTION FOR
INTERIM AND FINAL ORDERS (I) AUTHORIZING SECURED
POST-PETITION FINANCING ON A SUPER PRIORITY BASIS PURSUANT
TO 11 U.S.C. §§ 363, 364 AND 507(b); (II) GRANTING RELIEF FROM THE
AUTOMATIC STAY PURSUANT TO 11 U.S.C. § 362; (III) GRANTING
RELATED RELIEF; AND (IV) SCHEDULING A FINAL HEARING
PURSUANT TO BANKRUPTCY RULE 4001
(Relates to Dkt. No. 31)**

TO THE HONORABLE LETITIA Z. PAUL,
UNITED STATES BANKRUPTCY JUDGE:

Comes now the Texas Health and Human Services Commission (“HHSC”) and Texas Department of State Health Services (“DSHS” and together with HHSC, the “State”) through the Texas Attorney General’s Office and respectfully file this Limited Objection to Debtors’ Emergency Motion for Interim and Final Orders (i) Authorizing Secured Post-Petition Financing on a Super Priority Basis Pursuant to 11 U.S.C. §§ 363, 364, and 507(b); (ii) Granting Relief from the Automatic Stay Pursuant to 11 U.S.C. § 362; (iii) Granting Related Relief; and (iv) Scheduling a Final Hearing Pursuant to Bankruptcy Rule 4001 (Docket No. 31) (the “Motion”). In support thereof the State would respectfully show as follows:

**EXHIBIT
A**

I. Background Facts

1. On February 27, 2015 (the “Petition Date”), the debtors and debtors in possession in the above captioned cases (collectively, the “Debtors”) each commenced a case by filing a petition for relief under chapter 11 of the United States Bankruptcy Code.

2. The Debtors continue to manage and operate their businesses as debtors in possession pursuant to Bankruptcy Code sections 1107 and 1108.

3. To date, no official committee of unsecured creditors has been appointed by the Office of the United States Trustee for the Southern District of Texas. No trustee or examiner has been appointed in the Chapter 11 cases.

4. On March 2, 2015, the Debtors filed the Motion, which seeks immediate authority on an interim basis for a debtor-in-possession secured financing facility (“Post-Petition Financing”) to provide funding for the operating expenses and working capital needs of the Debtors, and have also requested a hearing for final approval of the proposed Post-Petition Financing. *See* Motion, ¶ 1. The State appreciates the Debtors’ need for liquidity to continue operations, and does not object to the Debtors obtaining post-petition financing for that purpose. However, the State objects to the Motion and relief sought therein to the extent that it (1) seeks to cut off HHSC’s right to recoupment with respect to Medicaid overpayments, and (2) fails to include a carve-out for costs associated with maintenance and disposal of patient medical records in accordance with applicable nonbankruptcy law or the alternate provisions contained in 11 U.S.C. § 351. Further, the State reserves its right to object to the Motion seeking an order on a final basis on other, additional grounds, as the Motion was filed on an emergency basis and seeks approval of an 80-plus page credit facility, which the State continues to review.¹

¹ Counsel for HHSC and DSHS has discussed this with counsel for the Debtors and intends to contact counsel for the proposed post-petition lender to see if the parties can resolve the matters raised herein. However, in light of the

II. The State's Limited Objection to the Debtors' Motion

A. The Debtors' Motion and Proposed Interim Order Impermissibly Seeks to Cut Off HHSC's Recoupment Rights.

5. The Debtors' proposed Interim Order provides, in part:

MidCap's first priority Lien on the Debtors' Accounts (and proceeds therefrom) shall be senior to any right of a holder of a claim, including without limitation, any mortgagee, Governmental Authority or landlord, that arose, or is deemed to arise, prior to the Filing Date, of any right of set off, tax lien, tax levy, or to otherwise assert a charge against, or (except as set forth in Paragraph 11 of this Order) to recoup, such claim against any such Accounts. ("Governmental Authority," as used in this Order, means and includes any "governmental unit" as defined in Bankruptcy Code §101(27) and specifically includes, without limitation, the federal and state agencies and their intermediaries administering the Medicare and Medicaid programs with which the Debtors deal.) In addition, pursuant to Bankruptcy Code §§105 and 362, any such holder shall be stayed and prohibited from asserting any such setoff or other charge, or recoupment rights against the Debtors' Accounts (except as set forth in paragraph 13 of this Order).

See Dkt. 31-1 (proposed interim order) at ¶ 9. HHSC asserts that this is improper and would contravene both the contractual obligations of the Debtors as well as applicable Fifth Circuit authority on the doctrine of recoupment. The contractual agreement between HHSC and the Debtors, by which the Debtors became a Medicaid provider, entitles the appropriate Debtor to receive reimbursement for services rendered. However, in the event it is determined that an overpayment occurred, the agreement also expressly provides that HHSC can recoup such overpayments from funds that would otherwise be payable to the appropriate Debtor. HHSC also has a common law right to recoup any overpayments. Such recoupment rights may not be circumvented by a lien on the reimbursements in favor of the proposed post-petition lender.

6. Further, recoupment of Medicaid (or Medicare) overpayments is neither subject to the automatic stay nor limited to prepetition or postpetition claims against the Debtors.

emergency nature of the matter, HHSC and DSHS determined it necessary to file its objection to preserve its rights and apprise the Court of the issues in dispute.

Accordingly, HHSC objects to the entry of any interim or final order that affects such recoupment rights.

The Recoupment Doctrine

7. In bankruptcy, recoupment allows a party to reduce an obligation to the bankruptcy estate by the amount of the claim against the estate. The ability of a creditor to recoup against a debtor crosses over the petition date as it “allows reduction of a prepetition claim against the debtor by application of the claim to reduce a post-petition obligation to the debtor.” *Sacramento Mun. Util. Dist. v. Mirant Ams. Energy Mktg., LP, (In re Mirant Corp.)*, 318 B.R. 377, 381 (Bankr. N.D. Tex. 2004) (citing *Kosadnar v. Metropolitan Life Ins. Co. (Matter of Kosadnar)*, 157 F.3d 1011, 1016 (5th Cir.1998); *Sims v. U.S. Dept. of Health and Human Svcs. (In re TLC Hosps., Inc.)*, 224 F.3d 1008, 1011 (9th Cir. 2000). The Fifth Circuit has explained that “[r]ecoupment allows a defendant to reduce the amount of a plaintiff’s claim by asserting a claim against the plaintiff *which arose out of the same transaction* to arrive at a just and proper liability on the plaintiff’s claim.” *Holford v. Powers (Matter of Holford)*, 896 F.2d 176 (5th Cir. 1990) (emphasis in original); *see also Mirant*, 318 B.R. at 380.

8. In order for the doctrine of recoupment to apply, two minimum requirements must be met. First, some type of overpayment must have been made. *Kosadnar*, 157 F.3d at 1014; *but see (In re Eggers)*, 432 B.R. 577 (Bankr. W.D. Tex. 2010) (stating that the Fifth Circuit’s decisions in *Kosadnar* and *Herod v. Southwest Gas Corp. (In re Gasmark, Ltd.)*, 193 F.3d 371 (5th Cir. 1999) do not create a requirement that an overpayment occurred). Second, the claims of both the debtor and the creditor must arise out of the “same transaction.” *Kosadnar*, 157 F.3d at 1014.

9. As to the first requirement, an overpayment may be demonstrated by showing “harm to a creditor or benefit to a debtor in excess of that contemplated by the Code.” *Mirant*, 318

B.R. at 382. As to the second requirement, in order to determine whether the “same transaction” requirement has been satisfied, courts in the Fifth Circuit should focus “on the facts and the equities of each case.” *Id.* at 381-82 (citing *Kosadnar*, 157 F.3d at 1015). Merely showing that the claims arise under one contract does not satisfy “same transaction” question. *Id.* at 381.

10. The Fifth Circuit has contrasted recoupment with setoff by explaining that “setoff involves a claim of the defendant against the plaintiff which arises out of a transaction which is different from that on which the plaintiff's claim is based.” *Holford*, 896 F.2d at 178. Recoupment, on the other hand, is viewed as defense to the debtor’s claim against the creditor rather than as a mutual obligation. *University Medical Ctr. v. Sullivan (In re University Medical Ctr.)*, 973 F.2d 1065, 1079-80 (3d Cir. 1992). In the bankruptcy context, recoupment is often applied when the claims arise out of a single contract “that provide[s] for advance payments based on estimates of what ultimately would be owed, subject to later correction.” *Id.* at 1080 (internal citations omitted). An express contractual right is neither necessary nor sufficient to enable a creditor to effect a recoupment. *Id.*

11. Recoupment is not subject to the limitations of 11 U.S.C. § 553 (setoff) or the automatic stay. *Malinowski v. New York State Dept. of Labor (In re Malinowski)*, 156 F.3d 131, 133 (2d Cir. 1998); *University Medical Ctr.*, 973 F.2d at 1080; *Holford*, 896 F.2d at 179; *AHN Homecare, LLC. V. Home Health Reimbursement and Health Care Fin. Admin. (In re AHN Homecare, LLC)*, 222 B.R. 804 (Bankr. N.D. Tex. 1998); *Mirant*, 318 B.R. at 380-81. The Court in *Malinowski* explained that “[t]he automatic stay is inapplicable, because funds subject to recoupment are not the debtor's property.” *Id.*; see also *Holford*, 896 F.2d at 179. Instead, the trustee takes estate property subject to any recoupment rights. *Holford*, 896 F.2d at 178; *Aetna U.S. Healthcare, Inc. v. Madigan et al. (In re Madigan)*, 270 B.R. 749, 754 (B.A.P. 9th Cir. 2001).

A Super Priority Lien May Not Cut Off HHSC's Right to Recoupment

12. It is clear that the ability of HHSC to recoup overpayments to the Debtor, even regarding prepetition overpayments, may not be cut off by any postpetition financing or cash collateral order. This is true because “funds subject to recoupment are not the debtor’s property.” *Id*; see also *Holford*, 896 F.2d at 179; *Aetna Life Ins. Co. v. Bram (In re Bram)*, 179 B.R. 824, 827 (Bankr. E.D. Tex. 1995). Instead, the trustee or debtor-in-possession takes estate property subject to any recoupment rights. *Holford*, 896 F.2d at 178; *Madigan*, 270 B.R. at 754; *Bram*, 179 B.R. at 827.

13. As a debtor or trustee may not permit creditors to place liens on property that they do not own (see *American Nat. Bank and Trust Co. of Chicago v. Matrix IV, Inc. (In re S.M. Acquisition Co.)*, 319 B.R. 553, 555 (Bankr. N.D. Ill. 2005)), it stands to reason that any lien pursuant to the proposed order and post-petition financing documents cannot cut off HHSC’s rights to recoup monies that are not property of the estate. Accordingly, HHSC objects to any attempt to cut off or otherwise subordinate the right to recoup overpayments from Medicaid (or Medicare).

B. Any Final Order Authorizing Post-Petition Financing Should Contain a Carve-Out of Funds for Storage and Disposal of Debtors’ Patient Medical Records.

13. The Motion seeks entry of an interim order which would provide a carve-out (the “Carve-Out”) of \$250,000.00 for certain professional fees from the superpriority liens sought in favor of the proposed post-petition lender. See Dkt. No. 31-1 (proposed interim order) at ¶ 10. However, it appears that the relief requested on a final basis fails to provide a carve-out for costs

associated with the maintenance of patient medical records as required by applicable state law² or the alternative provisions of 11 U.S.C. § 351.³

14. As debtors-in-possession, the Debtors are required by statute to operate its business in compliance with applicable state law. Federal law is clear on this point. 28 U.S.C. § 959(b)

² See 25 T.A.C. § 133.41(j)(8). Upon information and belief, patient medical records in the Debtors' possession would be subject to this provision.

³ It is clear that the Section 351 of the Bankruptcy Code sets forth the minimum requirements for notice and maintenance of patient records before they can be disposed of and further, that costs incurred in complying with Section 351 are an administrative expense of the estate. 11 U.S.C. § 503(b)(8)(A).

Section 351 provides:

If a health care business commences a case under chapter 7, 9, or 11, and the trustee does not have a sufficient amount of funds to pay for the storage of patient records in the manner required under applicable Federal or State law, the following requirements shall apply:

(1) The trustee shall--

(A) promptly publish notice, in 1 or more appropriate newspapers, that if patient records are not claimed by the patient or an insurance provider (if applicable law permits the insurance provider to make that claim) by the date that is 365 days after the date of that notification, the trustee will destroy the patient records; and

(B) during the first 180 days of the 365-day period described in subparagraph (A), promptly attempt to notify directly each patient that is the subject of the patient records and appropriate insurance carrier concerning the patient records by mailing to the most recent known address of that patient, or a family member or contact person for that patient, and to the appropriate insurance carrier an appropriate notice regarding the claiming or disposing of patient records.

(2) If, after providing the notification under paragraph (1), patient records are not claimed during the 365-day period described under that paragraph, the trustee shall mail, by certified mail, at the end of such 365-day period a written request to each appropriate Federal agency to request permission from that agency to deposit the patient records with that agency, except that no Federal agency is required to accept patient records under this paragraph.

(3) If, following the 365-day period described in paragraph (2) and after providing the notification under paragraph (1), patient records are not claimed by a patient or insurance provider, or request is not granted by a Federal agency to deposit such records with that agency, the trustee shall destroy those records by--

(A) if the records are written, shredding or burning the records; or

(B) if the records are magnetic, optical, or other electronic records, by otherwise destroying those records so that those records cannot be retrieved.

11 U.S.C. § 351 (2012).

provides, in pertinent part, that “a trustee . . . (or) a debtor in possession shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated. . . .”

15. Without a lien carve-out for the proper maintenance of medical records, there will in all likelihood be insufficient unencumbered funds for the estate to maintain its obligations under state law in the event the case converts to Chapter 7 and a trustee is saddled with the burden of maintaining such records in accordance with applicable law. DSHS respectfully contends that the Carve-Out (as defined in the proposed interim order or provided for in any final order) should be amended to include sufficient funds to provide for the maintenance of the patient medical records in accordance with applicable state law or the alternative provisions of section 351. If the Debtor successfully reorganizes, or ends up in a sale scenario and the buyer takes possession of the patient records, the issues related to maintenance and storage of the Debtor’s patient medical records in accordance with applicable state law will be moot.

III. Relief Requested

16. Based on the foregoing, HHSC respectfully requests that the Court include the following proposed language in any final postpetition financing or cash collateral order to preserve such recoupment rights:

Notwithstanding anything contained in the Motion or this Order to the contrary, nothing herein shall affect the rights of any Governmental Unit, including but not limited to the Texas Health and Human Services Commission, from exercising its rights of recoupment, but the Debtor In Possession or any Trustee subsequently appointed shall retain its right to exhaust administrative remedies to contest the dollar amount of any recoupment(s) effectuated.

17. In addition, DSHS respectfully requests that the Court include the following proposed language in any final postpetition financing or cash collateral order to provide an appropriate carve-out for costs associated with the maintenance of patient medical records as required by applicable state law or the alternative provisions of 11 U.S.C. § 351:

Notwithstanding any other provision of this Order or the underlying Motion for Final Order to the contrary, all liens on and security interests in the Cash Collateral recognized by or granted pursuant to this Order, as applicable, and all super priority administrative claims granted pursuant to this Order, shall be subordinate to any fees and expenses associated with the retention, storage and/or transportation of all medical records in the Debtors' possession in accordance with applicable State and Federal law.

Such fees and expenses associated with this "Records Carve-Out" shall constitute an allowed administrative expense claim or claims pursuant to 11 U.S.C. § 503(b).

WHEREFORE, the Texas Health and Human Services Commission and the Texas Department of State Health Services respectfully object to the entry of a final order on cash collateral and/or postpetition financing that does not adequately preserve the State's Medicaid recoupment rights or that fails to fund the Debtors' obligations to maintain, and ultimately dispose of, its patient medical records.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a true and correct copy of the foregoing has been served via the Court's Electronic Filing System on all parties requesting notice in this proceeding and that copies were mailed to the counsel and parties listed below, via first class U.S. Mail, postage prepaid on March 3, 2015.

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