THIS OPINION IS NOT INTENDED FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

In re:	)	Case No. 03-25461
	)	
DEACONESS HOSPITAL, LLC, *et al.*,	)	Chapter 11
	)	(jointly administered)
Debtors.	)	
	)	Judge Pat E. Morgenstern-Clarren
	)	
	)	**MEMORANDUM OF OPINION**

Deaconess Hospital, LLC, Pearlview Square, Inc., and Indoga, Inc. filed these related chapter 11 reorganization cases on November 21, 2003. The cases are being jointly administered.[1] On December 1, 2003, the United States trustee (UST) filed an emergency motion to convert the cases to liquidating cases under chapter 7 or alternatively to appoint a chapter 11 operating trustee to replace current management. Creditor Quality Professional Staffing, Inc. supports the motion. The debtors oppose it.[2] The court held a hearing on the motion on December 4, 2003. For the reasons stated below, the UST's motion is denied without prejudice as premature.

JURISDICTION

Jurisdiction exists under 28 U.S.C. § 1334 and General Order No. 84 entered by the United States District Court for the Northern District of Ohio. This is a core proceeding under 28 U.S.C. § 157(b)(2)(A).

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[1] Docket 13.

[2] Docket 39, 54, 56.

FACTS

A. Background

Deaconess Hospital, LLC (Deaconess) is a for-profit acute care facility in Cleveland's Old Brooklyn neighborhood. Deaconess has 260 licensed beds of which 100 have been in use over the last three years. George Saad, M.D. is the CEO of Deaconness. He is also the CEO of affiliated entities Pearlview Square, Inc. (Pearlview), and Indoga, Inc. Pearlview owns the real estate and improvements where Deaconess operates and Indoga owns the parking garage connected to Deaconess. Pearlview and Indoga lease their property to Deaconess. All three entities filed for chapter 11 protection on November 21, 2003.

Dr. Saad began his affiliation with the Deaconess facility in 1975, serving as a member of the surgical staff and later as chief of surgery. In 2000, he formed a limited liability company to purchase Deaconess from the Primary Health Systems bankruptcy estate. GE HFS Holding, Inc.[3] provided a line of credit to fund Deaconess's operations and Bank One financed the real estate acquisition. Dr. Saad personally guaranteed part of the GE debt.

Deaconess's finances have been deteriorating since October 2000. By September 2001, Deaconess could no longer make its monthly rent payments to Pearlview or to Indoga. That same month, Deaconess stopped paying management fees to Noar Management, also owned by Dr. Saad. Noar, however, continued to provide services such as overseeing the real estate and dealing with lenders. Over time, money became so tight that Dr. Saad loaned a total of $1.4 million to Deaconess to fund payrolls and pay for pharmaceuticals and medical supplies. And in September 2003, Deaconess Radiological Services, Inc. and Deaconess Emergency Room

[3] The lender was formerly known as Heller Healthcare Financial, Inc.

Services, Inc., non-debtor entities owned by Dr. Saad, pledged their accounts receivable to GE in exchange for additional funding.

Unfortunately, these efforts proved insufficient to keep Deaconess afloat. Most or all Deaconess suppliers put Deaconess on a COD basis or required payment by wire transfer before the goods were delivered. Faced with numerous financial problems, Deaconess, Pearlview, and Indoga filed these chapter 11 cases. At that time, Deaconess had 325 employees.

B. The debtors' postpetition funding

The debtors filed several motions at the outset, including motions to pay prepetition employee wages, to use GE's cash collateral on an interim and final basis, and for authority to enter into a postpetition financing agreement with GE because the debtors did not have enough funds to pay operating expenses.[4] The employee wage motion was granted without objection.[5] The cash collateral issue was temporarily resolved through agreed orders granting the debtors the right to use GE's cash collateral through December 22, 2003 subject to conditions, with the final hearing set for December 18, 2003.[6]

The postpetition financing motion was heard on November 26, 2003. Dr. Saad, testifying in support of the motion, stated that Deaconess intended to continue its operations. It did not, however, have enough money to meet its payroll due on November 28, 2003 or to pay its suppliers without additional financing from GE. He testified further that the hospital had more than 50 in-patients at that time. GE's counsel stated that GE would provide funds to the debtors

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[4] Docket 4, 7, and 22. *See* 11 U.S.C. §§ 363(c)(2) and 364.

[5] Docket 16.

[6] Docket 15, 52.

subject to certain conditions, including an additional personal guarantee from Dr. Saad. The court entered an agreed order that same day granting the motion.[7]

C. The events of November 26, 27, and 28, 2003

Based on Dr. Saad's testimony at the hearing on the UST's motion, these events unfolded on November 26 late in the day, and on November 27 and 28, 2003:

After the court hearing on November 26th, Dr. Saad felt that GE had agreed to increase the debtors' borrowing base by $250,000.00 in exchange for Dr. Saad's increasing his personal guarantee. He believed this would provide the debtors with enough funds to make the payroll, plus have an additional $250,000.00 to purchase pharmaceuticals and supplies and to pay the house physicians. An acute care hospital is required to have house physicians in attendance 24 hours a day, 7 days a week to care for in-house patients.

Dr. Saad testified that he signed the personal guarantee. Despite this, GE only advanced enough funds that day for the payroll.[8] Dr. Saad did not know why GE refused to advance the additional $250,000.00. and there was no testimony explaining the refusal.

Dr. Saad was then faced with a situation where vendors said they would not deliver goods on Friday unless payment was wire transferred on Wednesday (Thursday November 27th being Thanksgiving) and house physicians said they would stop working on Friday at 7:00 p.m. if they were not paid. He attempted to negotiate with other hospitals for pharmaceuticals, but was unsuccessful. He also tried to negotiate with the house physicians to see if they would at least work until Monday, December 1 when he could reach GE. They refused. Next, Dr. Saad called

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[7] Docket 32.

[8] This was about $515,000.00.

other physicians to cover the shifts, but the people he contacted did not want to work shifts over the holiday weekend.

As Friday wore on, Deaconess had a dangerously short supply of pharmaceuticals and medical supplies. The house physicians then carried out their threat and did not appear for the 7:00 p.m. shift. At that point, Deaconess took two steps: (1) it called Cleveland's emergency medical services to advise that it could not accept any more patients through the emergency room because it was closing; and (2) it transferred the remaining 28 or so patients via ambulance to other hospitals. Deaconess notified the attending physicians of the transfer before the move and the patient families after the move.

Following the patient evacuation, Deaconess arranged security at the facility, controlled the manner in which employees were allowed to enter the building to remove personal belongings, and made patient records available to physicians. Twenty-one employees remain; they are the chief financial officer, director of nursing, and director of operations, as well as personnel in accounting, cleaning, medical records, and telecommunications. The nursing director is the only person with access to pharmaceuticals and regulated drugs. The drug enforcement agency inspected Deaconess the day before the hearing and gave it "high marks" in this area. Similarly, a regulatory agency inspected for nuclear waste and also gave the facility "high marks."

Cleveland city ordinances require a health care facility to give advance notice to the city when, among other acts, it reduces operations or closes. *See* CLEVELAND, OH. ORDINANCE chs. 396 and 686. The ordinances are intended to address public health concerns, including issues such as fire hazards, medical waste, and other solid waste. Violation of the ordinances is a first

degree misdemeanor. Deaconess did not give advance notice of its closing to the city.[9] The city filed multi-count complaints against Dr. Saad and Deaconess in housing court alleging violations of these ordinances.[10]

Although GE did not advance the additional funds needed by Deaconess, the parties are continuing financing negotiations. The debtors plan to apply to retain an investment banker whose job it will be to identify reorganization alternatives, including resuming operations as a private acute care hospital, resuming operations as a not-for-profit hospital, obtaining a capital infusion that would permit the debtors to continue to provide some medical services to the community, and/or selling some or all of the debtors' assets.

THE POSITIONS OF THE PARTIES

The UST argues that cause exists to convert the cases to chapter 7 because the debtors do not have sufficient funds to operate, do not have a financing commitment, and do not have any patients, all of which adds up to an inability to reorganize under chapter 11. Alternatively, he argues that cause exists to appoint a chapter 11 operating trustee because of the named factors, as well as the fact that Dr. Saad made misrepresentations of fact to the court concerning the number of patients at the hospital and closed the facility without complying with applicable city code provisions or giving adequate notice to patients' families.

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[9] The court is not making any finding as to whether that failure to act violated the ordinances.

[10] The UST offered the housing court complaints into evidence without objection from any other party. The court accepted them into evidence. (UST Exh. 1). Witnesses also testified about the complaints. The debtors' post-trial effort to object to this evidence is untimely. (Docket 76).

Creditor Quality Professional Staffing, Inc. supported the UST's motion, contending that the debtors had improperly billed medicare and/or medicaid for nursing agency services that the debtors had not paid for. There was no evidence to support this and it will not be discussed further in this opinion.

The debtors object to the UST's motion. They point out that this case is only days old and claim they have not been given a fair chance to reorganize. They argue further that Dr. Saad acted responsibly in transferring the patients, that the number of in-patients is irrelevant to Deaconess's income, and that several individuals and entities are interested in doing something with the debtors' facilities.

The UST and the debtors treated all three debtors essentially as one entity in their arguments and made no separate arguments for Pearlview or Indoga. The court will do the same.

DISCUSSION

A. 11 U.S.C. § 1112(b)

Under bankruptcy code § 1112(b), a chapter 11 case may be dismissed or converted to a chapter 7 liquidation case:

> (b) . . . on request of a party in interest or the United States trustee . . . , and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title or may dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, for cause, including–
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> (2) inability to effectuate a plan[.]

11 U.S.C. § 1112(b)(2). To show cause to convert,[11] the UST argues that the debtors cannot put

[11] At the hearing, the UST disclaimed any interest in having the case dismissed.

together a plan of reorganization without financing. He emphasizes that the debtors have stopped treating patients and they may be liable for criminal sanctions for violating city ordinances. The UST has the burden of proving by a preponderance of the evidence that cause exists to convert. *See In re Woodbrook Assocs.*, 19 F.3d 312, 317 (7th Cir. 1994).

Cause to convert can be found in two places: (1) the specific circumstances listed in § 1112(b)(2); or (2) because that list is not exclusive, in any other relevant factors. *See In re V Cos.*, 274 B.R. 721, 725 (Bankr. N.D. Ohio 2002) (citations omitted) (factors other than those listed in § 1112(b) may also amount to cause). In any event, a finding that cause exists must be based on a totality of the circumstances. *See Trident Assocs. Ltd. P'ship v. Metro. Life Ins. Co. (In re Trident Assocs. Ltd. P'ship)*, 52 F.3d 127, 131 (6th Cir. 1995).

"[A]n inability to effectuate a plan 'means that the debtor lacks the ability to formulate a plan or to carry one out'." *In re New Batt Rental Corp.*, 205 B.R. 104, 108 (Bankr. N.D. Ohio 1997) (quoting *Hall v. Vance*, 887 F.2d 1041, 1044 (10th Cir. 1989)). Cause can also exist where a debtor stops doing business. *See for example, In re Fund Raiser Prods. Co.,* 163 B.R. 744, 751 (Bankr. E.D. Pa. 1994) (granting conversion after relief from stay had been granted and the debtor was not operating); *In re Minnesota Alpha Found.*, 122 B.R. 89, 94 at n.10 (Bankr. D. Minn. 1990) (noting that chapter 7 is the preferred vehicle for liquidation under the bankruptcy code except in unusual circumstances).

In this case, as in most reorganization cases, the evidence showed that the debtors are in deep financial trouble, a situation that has been developing over the last few years. What is unusual is that after the debtors obtained postpetition financing, they abruptly stopped operations due to unforeseen complications with the lender. No party questioned the good faith of the

management in concluding that it had to close the facility to protect the patients when it had no money for staff or supplies. The city does, however, claim that the management violated the law in closing without giving city authorities at least 30 days notice. That non-bankruptcy issue will be decided another day in another court. For bankruptcy purposes, it was obviously impossible for the management to give 30 days notice to anyone. Under the circumstances, management behaved responsibly in transferring the patients and securing the facility, with one important exception: they should have communicated the problem and their proposed solution promptly and directly with parties in interest, including the UST, the city, and patient families.

The debtors continue to negotiate with GE on the funding issue. As of the hearing date, the possibility that the debtors could or should resume operations as a full service, acute care facility seemed remote. The bankruptcy code, however, gives a debtor a fair amount of flexibility in proposing a plan. For example, a plan does not necessarily have to propose continuing operations; it may focus instead on an orderly liquidation of all or some of the assets. *See* 11 U.S.C. § 1123(b)(4). The debtors here have suggested that as one possible alternative. If so, the absence of financing and dearth of patients would not prevent the debtors from coming forward with such a plan.

While this is a very close call, the court concludes that the debtors have not yet had a fair chance to show that they will be able to effectuate a plan. This case had only been pending for 10 days when the UST filed his motion, triggered by the debtors' actions. The UST properly brought the issue to a head through his motion. Having now had the benefit of the explanation for the Thanksgiving weekend closure, however, the court finds that it is premature at this point to convert to chapter 7. A conversion would require the appointment of a chapter 7 trustee (another

layer of expense) who would investigate the asset situation and liquidate available assets. Through no fault of trustees, the forced liquidation is sometimes done at bargain prices for buyers which result in diminished returns to creditors. The debtors will be given additional time to propose a better alternative, but the time frame will be short. The UST's motion to convert these cases to chapter 7 is, at this point, denied without prejudice.

B. 11 U.S.C. § 1104(a)

Alternatively, the UST moves to appoint a chapter 11 trustee as serving the interests of all parties because the debtors lack adequate managerial control. His motion is based on bankruptcy code §1104(a)(2):

> (a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee –
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> * * *
>
> (2) if such appointment is in the interests of creditors . . . [and] other interests of the estate[.]

11 U.S.C. § 1104(a)(2). There is, however, a strong presumption that a chapter 11 debtor should be permitted to remain in control of its affairs. *See In re Marvel Entm't Group, Inc.*, 140 F.3d 463, 471 (3d Cir. 1998). The UST must, therefore, prove its case by clear and convincing evidence. *Id.*

Section 1104(a)(2) "creates a flexible standard, instructing the court to appoint a trustee when doing so addresses 'the interests of the creditors, equity security holders, and other interests of the estate'." *In re Sharon Steel Corp.*, 871 F.2d 1217, 1226 (3d Cir. 1989). Relevant considerations include: (1) the debtor's trustworthiness; (2) the debtor's past and present

performance and its prospects for rehabilitation; (3) the confidence of creditors and the business community in the debtor; (4) the benefits to be derived from the appointment of a trustee compared to the costs of the appointment; and (5) whether a trustee could accomplish the goals of a chapter 11 plan more efficiently and effectively than the debtor in possession. *See Schuster v. Dragone,* 266 B.R. 268, 273 (D. Conn. 2001); *In re Ionosphere Clubs, Inc.*, 113 B.R. 164, 168 (Bankr. S.D. N.Y. 1990). When a debtor's business has an effect on the general public, the public interest is also a factor which must be considered. *In re Ionosphere Clubs, Inc.*, 113 B.R. at 168. The appointment of a trustee under § 1104(a)(2) is left to the bankruptcy court's discretion. *See Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 501 (6th Cir. 1990) (noting that § 1104(a)(2) tracks a provision for the appointment of an examiner and "in both cases the appointment is left to the bankruptcy court's discretion.").

The UST argues that the appointment of a trustee with expertise in the management and wind-down of health care operations will best serve the interests of all the parties in these cases. A trustee is needed (according to the UST) to protect patient records, inventory pharmaceuticals, identify and collect accounts receivables and insurance claims, and liquidate in accordance with applicable regulations. The facts presented at the hearing, however, show that this request is premature. The debtors presented uncontraverted evidence that, having made the decision to close the facility, they acted reasonably in carrying out that plan vis a vis the patients and the building. Patient records have been protected and are being made available to physicians, the facility has been padlocked and security is in place, and attempts to bill and collect accounts receivable are ongoing.

Although the debtors have not operated profitably in the past, they are pursuing reorganization alternatives and may hire an investment banker to help them in that effort. Only one unsecured creditor spoke in support of the motion, and that creditor did not establish the factual ground on which it based its objection. There was no evidence that the management is incompetent, corrupt, or incapable of heading a reorganization effort. Dr. Saad is not currently drawing a salary and no payments are being made to insiders. If a chapter 11 operating trustee is appointed to replace current management, the appointment will add a significant layer of administrative expense, all of which will be paid before any funds go to creditors. The expense includes not just the trustee's compensation, but also fees and costs incurred when the trustee retains professionals (lawyers, accountants, and consultants) to assist in the performance of the trustee's responsibilities.

The troubling part of all of this, as noted above, is that the debtors closed the facility without contemporaneously involving other parties in interest. Having invoked the protection of the bankruptcy code, a debtor in possession is expected both to carry out its responsibilities and to respect the role that other parties play. At the beginning of a case, a debtor sometimes stumbles with respect to this obligation. In this case, the debtors carried out their fiduciary responsibilities when they closed the facility, but they fell more than a little short in including others in that important series of events. The court trusts that this will not happen again.

Along these same lines, the UST raised the issue of the debtors' inconsistent representations at hearings about the number of occupied beds. The debtors argue that if there is a discrepancy it was caused by confusion between the actual number of beds occupied on any one day as compared to the average monthly patient census, linked to the debtors' borrowing

covenants with GE. GE has not claimed any violation of those covenants. Given the point in the proceedings in which these statements were made, the court gives the debtors the benefit of the doubt this one time, but cautions them that full and accurate disclosure is the hallmark of bankruptcy cases. It is the debtors obligation to insure that a full explanation is provided for any term that may be vague or misunderstood.

In sum, although the UST has raised significant issues, he did not prove by clear and convincing evidence that appointing a chapter 11 operating trustee would presently serve the interest of creditors and the estate. The motion to appoint a trustee is, therefore, denied without prejudice.

CONCLUSION

For the reasons stated, the motion of the United States Trustee to convert or appoint a chapter 11 trustee is denied without prejudice. The court will enter a separate order reflecting this decision.

Date: 10 Dec 2003

Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

Served by telecopy on: Andrew Vara, Esq.
Daniel DeMarco, Esq.
Kenneth Freeman, Esq.

By: Joyce L. Gordon, Secretary

Date: 12/10/03

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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

In re:	)	Case No. 03-25461
	)	
DEACONESS HOSPITAL, LLC, *et al.*,	)	Chapter 11
	)	(jointly administered)
Debtors.	)	
	)	Judge Pat E. Morgenstern-Clarren
	)	
	)	**ORDER**

For the reasons stated in the memorandum of opinion filed this same date, the United States trustee's motion to convert to chapter 7 or to appoint a chapter 11 operating trustee is denied without prejudice. (Docket 39).

IT IS SO ORDERED.

Date: 10 December 2003

Pat E. Morgenstern-Clarren
United States Bankruptcy Judge

Served by telecopy on: Andrew Vara, Esq.
Daniel DeMarco, Esq.
Kenneth Freeman, Esq.

By: Joyce L. Gordon, Secretary

Date: 12/10/03