UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re **SAN BENITO HEALTH CARE DISTRICT dba HAZEL HAWKINS MEMORIAL HOSPITAL,** Debtor.	Case No. 23-50544 SLJ Chapter 9

ORDER FOLLOWING TRIAL ON CHAPTER 9 ELIGIBILTY FOR ORDER FOR RELIEF

California Nurses Association ("CNA") and National Union of Healthcare Workers ("NUHW" and with CNA, the "Objectors") object to the petition filed by San Benito Health Care District dba Hazel Hawkins Memorial Hospital (the "District") under chapter 9 of the Bankruptcy Code.[1] Both unions assert that the District is not insolvent and therefore not eligible to be a debtor. Additionally, NUHW asserts that the District did not file the

[1] Unless specified otherwise, all chapter, code and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and the Federal Rules of Bankruptcy Procedure, Rules 1001-9037. "ECF" refers to entries on the court's electronic docket.

petition in good faith. The court held a four-day trial from December 4 to 7, 2023. After the parties filed their closing briefs on January 5, 2024, the court took the matter under submission.

Chapter 9 cases are filed by State entities under the federal Bankruptcy Code. State entities are authorized to file chapter 9 cases in California under California Government Code § 53760 *et seq*. Federal law requires that municipalities satisfy a stringent test to qualify for relief. This ensures they are in bona fide financial distress before they are permitted to use federal law to impair existing contracts. The court concludes that the District has not met its burden of proving it is insolvent within the meaning of §§ 109(c) and 101(32)(C) and dismisses the petition.

The court is mindful that the District has faced an enormous financial challenge in the past several years. Its board of directors, officers, and staff responded to that challenge with innovative solutions and a sense of resilience. The court's conclusion that the District is not insolvent should be seen as a reflection of the District's concerted effort to ensure that its hospital can continue to serve the San Benito County community in the future.

I. BACKGROUND

A. Factual Background

The District is a California health care district formed under California Health and Safety Code § 32000 *et seq*. It operates multiple facilities in San Benito County, California, including a 25-bed acute care hospital known as Hazel Hawkins Memorial Hospital, two skilled nursing facilities, five rural health care clinics, two specialty clinics, and two laboratories. The District is the exclusive provider of certain healthcare services and the only emergency service provider in San Benito County, serving a population of nearly 64,000 residents. It is licensed as a Critical Access Hospital ("CAH") by the Centers for Medicare and Medicaid Services for providing healthcare services in a rural community. The CAH designation is meant to reduce the financial vulnerability of rural hospitals by receiving certain benefits, such as cost-based reimbursement for Medicare services.

The District employs approximately 678 employees, plus another 40 contract workers. Approximately 80% of the employees are represented by four unions under a collective bargaining agreement or memorandum of understanding ("CBA" or collectively, "CBAs"). These unions are the CNA, NUHW, Engineers and Scientists of California ("ESC"), and California Licensed Vocational Nurses' Association ("CLVNA") (collectively, the "Unions").

Prior to 2004, the District provided retirement benefits for almost all its full-time employees under a defined contribution matching plan ("Defined Contribution Plan"), in which the District's contributions matched the contributions of the employees up to a 3.5% limit. The Defined Contribution Plan currently includes 457 participants. From January 1, 2005, the District began a single-employer defined benefit plan ("Defined Benefit Plan"), or a pension plan. Nicolay Consulting Group ("Nicolay") is the District's independent actuary. As of the beginning of 2022, there were a total of 552 participants in the Defined Benefit Plan. Additionally, the District provides health benefits to employees through a self-funded plan ("Health Plan") in which the District collects premiums from employees and pays their and their dependents' medical claims.

A series of events led the District's Board of Directors to declare a fiscal emergency in November 2022. Medicare, through its third-party administrator, informed the District in June 2022 that it overpaid the District approximately $5.2 million, which it would have to pay back to Medicare through a 12-month repayment plan of approximately $441,000 per month. At the same time, Medicare adjusted its reimbursement rates so the District would receive approximately $450,000 less per month going forward. And because the District was out of contract with Anthem Blue Cross ("Anthem"), a primary private insurance payor, it had approximately $4 million in delayed claims between August and December 2022. The District also owed approximately $1 million for the employer's portion of the 2021 payroll taxes that was deferred under the CARES Act but was due at the end of 2022. Add in the lingering effects of the pandemic such as inflation for medical supplies and drugs, and extraordinary expenses to pay for traveling nurses to handle the influx of patients, the

District at one point was projected to have only 1.5 days' cash on hand in mid-December to pay for day-to-day operations. In a resolution passed on November 4, 2022 ("November Resolution"), the Board of Directors found that the District was or would be unable to pay its obligations within the next 60 days and was insolvent on a cash flow basis and authorized the District to file a petition under chapter 9. Said authority, however, terminated on December 31, 2022, if no petition had been filed by that date.[2]

The District and its bankruptcy counsel retained B. Riley Advisory Services ("B. Riley") around November 2022 to provide insolvency analysis and cash management consulting. The District took measures to stabilize its financial position and did not file bankruptcy in December 2022. It received an advance of its property tax revenue from San Benito County in December. It also received a loan of about $3 million from the State of California in January 2023. It negotiated a new contract with Anthem at the end of January. The District also negotiated a longer repayment plan for the Medicare overpayment, resulting in a reduction of monthly payments from $441,000 to approximately $69,000. It saved over $1 million per year by closing its home health department. It instituted a hiring freeze and sent out WARN notices notifying employees of potential layoffs. It began looking for a potential transaction partner for merger. B. Riley also put together a closure plan in February 2023.

Despite these efforts, filing bankruptcy remained on the table, and the District commenced the neutral evaluation process, one of two mutually exclusive requirements under California law prior to filing for bankruptcy relief, on February 4, 2023. It was concluded in early April 2023 without a resolution. On May 22, 2023, following a public hearing, the Board of Directors passed a resolution authorizing a bankruptcy filing ("May Resolution"). It also authorized the adoption of a pendency plan ("Pendency Plan"), which outlines the postpetition operational changes and reflects the structure of a potential chapter 9 plan.

On the next day, May 23, 2023, Debtor filed its voluntary petition under chapter 9.

[2] Debtor's Exhibit 23.

B. Procedural Background

The list of creditors discloses approximately 1,524 creditors holding more than $77 million in claims. On the petition date, Debtor filed a Statement of Qualifications and a Declaration of Mary Casillas in Support of Emergency First Day Motions ("Casillas Declaration"), ECF 10, outlining the District's operations, financial difficulties, and plan going forward. The court set a deadline for parties to object to the petition. Two parties filed objections to eligibility. CNA and NUHW both objected on insolvency grounds, asserting that the District is not insolvent as required by § 109(c)(3). NUHW also objected on the grounds that Debtor did not file the petition in good faith under § 921(c). The court entered a scheduling order setting the objections for a five-day trial commencing on December 4, 2023.

Prior to trial, Debtor filed a Motion in Limine to Exclude Expert Witness Melvin Hurley ("Motion in Limine"), arguing that CNA's expert witness Melvin Hurley ("Hurley") applied the incorrect legal standard for insolvency and impermissibly relied on postpetition facts in his analysis. Accordingly, the District contends that Hurley's testimony must be excluded prior to trial pursuant to *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579 (1993). The Motion in Limine was opposed by CNA. In an Order Denying Application for Order Shortening time, the court declined to rule on the Motion in Limine prior to trial. After the trial, the parties filed additional briefs pertaining to the Motion in Limine. The court denied the Motion in Limine in the Order Overruling Objection to Expert Testimony of Melvin Hurley, CPA ("Hurley Order"), entered concurrently herewith.

During the four-day trial,[3] the District presented the following witnesses: (1) Mary Casillas ("Casillas"), the District's interim CEO at the time and now the CEO; (2) Anne Olsen ("Olsen"), who is an employment attorney and was involved in negotiations with the Unions; (3) Carol Fox ("Fox"), a senior managing director at B. Riley who prepared the District's cash forecast; (4) Mark Robinson ("Robinson"), who is the District's CFO; and (5)

[3] Although the trial was set for five days, it was concluded in four days.

Craig Jacobson ("Jacobson"), a managing director in the valuation and litigation services of B. Riley who prepared the report on solvency analysis. CNA and NUHW presented the following witnesses: (1) Melvin Hurley, a CPA who prepared an expert report as discussed more fully in the Hurley Order; (2) Ian Lewis ("Lewis"), who worked for NUHW as a research director and interim political director, and (3) Ralph Cornejo ("Cornejo"), who negotiates labor contracts for NUHW.

As part of the Pendency Plan, B. Riley developed a cash forecast from May 2023 through December 2024 ("B. Riley Cash Forecast"). It included data showing actual cash balances from January 2023 through April 2023 calculated using B. Riley's methodology. According to Fox, the forecast was developed based on historical cash flow and the District's own projections regarding revenue. The B. Riley Cash Forecast has substantial differences when compared to the District's audited financial statements and its monthly internal financial statements, and this became a major point of contention during the trial. Another disputed issue is whether the District's contributions to the Defined Benefit Plan are contractual obligations that are due and owing. These issues are discussed in depth below.

II. DISCUSSION

The Bankruptcy Code has five mandatory requirements for eligibility as a chapter 9 debtor. The burden of establishing eligibility for relief lies with the debtor, but the eligibility requirements in § 109(c) are construed broadly to provide access to relief in furtherance of the Code's underlying policies. *In re City of Vallejo*, 408 B.R. 280, 289 (B.A.P. 9th Cir. 2009) (citations omitted). The standard for the burden of proof is preponderance-of-evidence. *In re City of Stockton, Cal.,* 475 B.R. 720, 726 (Bankr. E.D. Cal. 2012). If any one of the five requirements in § 109(c) are not met, the court must dismiss the case.

Additionally, if all of the § 109(c) requirements have been met, the court may still dismiss a chapter 9 petition under § 921(c) if the debtor did not file the petition in good faith. However, "[u]nlike the eligibility requirements of § 109(c), the court's power to dismiss

a petition under § 921(c) is permissive, not mandatory." *In re Pierce Cnty. Hous. Auth.*, 414 B.R. 702, 714 (Bankr. W.D. Wash. 2009); *City of San Bernardino, Cal.*, 499 B.R. 776, 790 (Bankr. C.D. Cal. 2013) (citing *Pierce Cnty. Hous. Auth.).*

The disputed issues presented by the objections and litigated during the trial are (1) whether Debtor is insolvent and (2) whether Debtor filed the chapter 9 petition in good faith.

A. Municipality

A debtor in chapter 9 must be a municipality under § 109(c)(1). The Bankruptcy Code defines "municipality" as a "political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 101(40). The District is a local hospital district organized and operated pursuant to California Health and Safety Code § 32000 *et seq*. This requirement is satisfied.

B. Authorization to File Chapter 9 Petition

A municipality can only seek relief under Chapter 9 if state law permits it. Section 109(c)(2) requires a debtor be *specifically authorized* to file chapter 9. § 109(c)(2). Under California law, a local public entity may file a petition under chapter 9 "if either of the following apply: (a) The local public entity has participated in a neutral evaluation process pursuant to Section 53760.3. (b) The local public entity declares a fiscal emergency and adopts a resolution by a majority vote of the governing board pursuant to Section 53760.5." Cal. Gov't Code § 53760. In other words, a municipality is authorized to file chapter 9 "by *either* pursuing a neutral evaluation process *or* declaring a fiscal emergency." *In re City of Stockton, Cal.*, 493 B.R. 772, 783 (Bankr. E.D. Cal. 2013) (emphasis added). In its Statement of Qualifications, the District relies on the first option.

According to the Casillas Declaration, the District initiated the confidential neutral evaluation process by selecting a neutral evaluator on February 4, 2023. Fox testified that invitations to participate in the neutral evaluation process were sent to four core groups, including the Unions, the secured debt holders, governmental agencies, and registry nurses.

Out of the four Unions, only one participated. Olsen testified that CNA and NUHW initially agreed to participate in the neutral evaluation process but cancelled, CLVNA declined to participate, leaving ESC as the only attendee. On April 12, 2023, the District provided notice to interested parties that the neutral evaluation process had concluded without a resolution of all pending disputes.

This requirement is uncontested and has been met by the District.

C. Desire to Effect a Plan to Adjust its Debts

The next requirement is that the debtor must possess a desire to effect a plan of adjustment. § 109(c)(4). There is "no bright-line test … for determining whether a debtor desires to effect a plan because of the highly subjective nature of the inquiry under § 109(c)(4)." *In re City of Vallejo*, 408 B.R. at 295. Using direct and circumstantial evidence, a debtor "may prove their desire by attempting to resolve claims [ ]; by submitting a draft plan of adjustment [ ]; or by other evidence customarily submitted to show intent. The evidence needs to show that the purpose of the filing of the chapter 9 petition not simply be to buy time or evade creditors." *Id.* at 295 (internal citations and quotation marks omitted); *see also In re City of Stockton, Cal.*, 493 B.R. at 791 ("At the first level, the question is whether the chapter 9 case was filed for some ulterior motive, such as to buy time or evade creditors, rather than to restructure the City's finances." (citations omitted)).

This requirement is uncontested. The evidence shows the District desires to effect a plan to adjust its debts. It held a public hearing on November 4, 2022, regarding its fiscal condition and took public comments, resulting in the Board of Directors making a declaration of fiscal emergency; it undertook various initiatives to stabilize its finances but at the same time had B. Riley complete a closure plan which provided an orderly closing of services, as necessary; it prepared a staff report and the Pendency Plan for the Board of Directors and conducted a public hearing on May 22, 2023; it completed the neutral evaluation process as required by California law; and the Board of Directors, after the public

hearing, passed resolutions authorizing the District to file bankruptcy and approving the Pendency Plan. These actions demonstrate the District's desire to effect a plan.[4]

D. Negotiations with Creditors

A debtor has four ways to satisfy § 109(c)(5), which addresses efforts to reach out to creditors before filing a bankruptcy case, including showing that the debtor --

> (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
>
> (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
>
> (C) is unable to negotiate with creditors because such negotiation is impracticable; or
>
> (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

§ 109(c)(5). The temporal focus of § 109(c)(5) is prior to the petition date. *In re Valley Health Sys.*, 383 B.R. 156, 161 (Bankr. C.D. Cal. 2008) ("Section 109(c)(5) is intended to promote pre-petition negotiations between a municipality and its creditors concerning a plan of adjustment."); *In re Connector 2000 Ass'n, Inc.*, 447 B.R. 752, 759 (Bankr. D.S.C. 2011) ("section 109(c)(5) requires a potential chapter 9 debtor to meet one of several alternatives relating to pre-petition workout attempts.").

In its Statement of Qualifications, the District asserts that it satisfied the requirements in § 109(c)(5)(B), (C) and (D). NUHW did not expressly object to eligibility on this ground in its objection. At the status conference on July 21, 2023, based on NUHW's counsel's comments, the court indicated that the § 109(c)(5) argument is subsumed by NUHW's

[4] NUHW argues that the District filed this case for the improper purpose of getting rid of the CBAs but does not object under § 109(c)(4). Debtor's proposal to adjust its debts, whether it involves rejecting the CBAs or proposing drastic cuts to the benefits therein, may not be to the unions' liking, or may not succeed, but it still reflects the District's desire to effect a plan for the purpose of § 109(c)(4).

broader good faith objection under § 921. Notwithstanding this discussion, NUHW added a separate argument under § 109(c)(5)(B) in its opening trial brief. During trial, the District raised the § 109(c)(5) issue, and the court responded, "It's not in play … There are two things that I'm deciding, Counsel. I'm deciding whether the District is insolvent and whether the District engaged in – acted in good faith. Yeah, they may have mentioned it in their brief, but it's not on my menu for today or for this week." T2, 47:10-15 (cleaned up).[5] NUHW did not raise § 109(c)(5)(B) in its closing brief. Regardless, the court has considered NUHW's argument and finds that the District satisfied the requirement in § 109(c)(5).

Taking the last option first, the District asserts that it "reasonably believes that, in light of its known financial challenges, that certain trade creditors have obtained, or may attempt to obtain, transfers that are voidable under § 547." Statement of Qualifications, p. 3: 4-5. Other than a conclusory declaration from Casillas that she believes every statement in the Statement of Qualifications is true and correct, the District did not provide any evidence to support this blanket statement, identify those trade creditors that have obtained avoidable transfers, or explain why its belief that creditors may attempt to obtain avoidable transfers is reasonable. *Compare In re Boise Cnty*, 465 B.R. 156, 169-70 (Bankr. D. Idaho 2011) (finding § 109(c)(5)(D) satisfied when the petitioner showed a specifically identified creditor's "increasingly aggressive attempts to collect on its judgment" through letters and an application for a writ).

That leaves the second and third options, which are focused on negotiations with creditors. "[T]he plain language of § 109(c)(5)(B) requires negotiations with creditors revolving around a proposed plan, at least in concept." *In re City of Vallejo*, 408 B.R. at 297.

The court understands that the CBA between NUHW and the District expired on June 30, 2022, and the parties have agreed to numerous extensions of the existing agreement without much progress in getting a new agreement in place. The negotiations for a new

[5] For convenience and brevity, the court will use "T1" to refer to the trial transcript for the first day of trial on December 4, 2023, "T2" for the second day of trial on December 5, 2023, "T3" for the third day of trial on December 6, 2023, and "T4" for the fourth day of trial on December 7, 2023.

contract began in September 2022 and have been acrimonious at best. But the negotiations at issue are not about coming up with a new agreement per se, because "[s]ection 109(c)(5) is intended to promote pre-petition negotiations between a municipality and its creditors *concerning a plan of adjustment*." *In re Valley Health Sys.*, 383 B.R. at 161 (emphasis added).

Olsen testified that she sent letters to each of the four Unions on or about April 18, 2023, asking to discuss the terms of the CBAs. Specifically, in one such letter sent to NUHW, the District identified certain topics for discussion, including the paid time-off plan, the Defined Benefit Plan, medical benefits, and stand-by compensation.[6] Similar letters were sent to the other Unions. Olsen further testified that she sent another letter to the Unions in mid-May 2023, informing them that a bankruptcy filing was imminent. NUHW admitted that in April 2023 the District reached out to bargain over the imminent bankruptcy filing and modification of the terms and conditions of the CBA. Declaration of Ralph Cornejo in Support of Objections by Creditor National Union of Healthcare Works to Debtor's Eligibility for Chapter 9 Relief ("Cornejo Declaration"), filed on July 14, 2023, ECF 84, p. 2:21-23. The District and NUHW met on April 28, May 15, June 16, July 3, and July 14 of 2023, and the evidence shows that more detailed proposals were exchanged, including but not limited to (1) proposals from the District dated April 28, 2023, and June 15, 2023; (2) proposal from NUHW dated July 3, 2023; and (3) proposal from the District dated July 14, 2023. NUHW complains that it did not receive a comprehensive and detailed proposal until June 16, 2023. Declaration of Ian Lewis in Support of Objections by Creditor National Union of Healthcare Works to Debtor's Eligibility for Chapter 9 Relief ("Lewis Declaration"), filed on July 14, 2023, ECF 85, p. 3:10-11; Cornejo Declaration, p. 4:6-7. But the main driver of NUHW's good faith argument is that the District refused to budge on its insistence to eliminate the Defined Benefit Plan.

The court does not need to decide whether the District's negotiating strategy constitutes bad faith because for the purpose of § 109(c)(5)(B), the focal point is prepetition negotiations. By the petition date, the District and NUHW had only two meetings and one

[6] Debtor's Exhibit 11.

round of proposal exchanges, namely the District's proposal dated April 28, 2023, and NUHW's verbal proposal at the May 15, 2023, meeting. Looking at this time period, the court cannot conclude that the District failed to negotiate in good faith. In essence, the parties ran out of time, but negotiations continued postpetition. The District cannot be faulted for the short prepetition negotiating window when NUHW declined to participate in the neutral evaluation process two months prior in February 2023. Furthermore, the Pendency Plan proposes to either reject the CBAs or modify their terms – the same terms that the District sought to adjust prepetition in the negotiations.

Alternatively, a debtor may show that negotiations with creditors were impracticable under § 109(c)(5)(C). Negotiation is impracticable where "(though possible) it would cause extreme and unreasonable difficulty." *In re Valley Health Sys.*, 383 B.R. at 163. "Whether negotiations with creditors is impracticable depends upon the circumstances of the case." *In re City of Vallejo*, 408 B.R. at 298. "Petitioners may demonstrate impracticability by the sheer number of their creditors or by their need to file a petition quickly to preserve their assets." *Id.* at 298.

The District alleges that negotiations were impracticable because of the negotiating positions of certain creditors and the refusal of certain critical creditors to participate. Neither NUHW nor CNA challenges the District's eligibility under §109(c)(5)(C). This provision does not apply to NUHW. Negotiations could not be impracticable when they commenced prepetition and continued postpetition, even if an agreement could not be reached postpetition. However, it does apply to CNA, based on Olsen's uncontroverted testimony that she believed CNA would not agree to any changes in the CBA from their communications and CNA's lack of participation in the neutral evaluation process.

Considering that labor expenses comprise approximately 70% of annual expenses, it would have been futile to negotiate with other creditors without an agreement with the Unions. The court finds that the District satisfies § 109(c)(5).

E. Insolvency

The parties dispute whether the District is insolvent. The Bankruptcy Code defines insolvency, in the context of a municipality, as one of two alternatives. Section 101(32) says:

> The term "insolvent" means--(C) with reference to a municipality, financial condition such that the municipality is--
>
> (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or
>
> (ii) unable to pay its debts as they become due.

§ 101(32)(C).

The first test for insolvency looks to the municipality's current payment status. The second test for insolvency is prospective, looking to the municipality's future ability to pay its debts. *In re Hamilton Creek Metro. Dist.*, 143 F.3d 1381, 1384 (10th Cir. 1998). The reference point of the insolvency analysis is the petition date. *Id.*; *In re Boise Cnty.*, 465 B.R. at 171.

The District contends that it is insolvent under both tests, and places reliance on the work of retained expert B. Riley for that conclusion. The Objectors contend otherwise.

1. Sec. 101(32)(C)(i) - Generally Not Paying Debts as They Become Due

To evaluate the first test, it is necessary to understand the meaning of "debts as they become due."

In interpreting a statute, the court is guided by its plain meaning. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989). And in ascertaining the plain meaning of § 101(32)(C), the Tenth Circuit explained: "'Due,' in the absence of qualification, means 'now (presently or immediately) matured and enforceable.' Black's Law Dictionary 499 (6th ed.1990); *see* Webster's New International Dictionary 699 (3d ed.1961) ('having reached the date at which payment is required'). A 'matured claim' is defined elsewhere by Black's as one that 'is unconditionally due and owing.' *Id.* at 979. As 'due' is unqualified in § 101(32)(C), combining these definitions yields: presently, unconditionally owing and presently enforceable." *In re Hamilton Creek Metro. Dist.*, 143 F.3d at 1385. "Accordingly, evidence of

when debts arose and amounts owed by a debtor without evidence of when the amounts are actually payable is insufficient to prove the petitioner is not meeting its debts." *In re Boise Cnty.*, 465 B.R. at 172 (citing *Hamilton Creek*).

a. The District Conceded it is Paying its Debts as They Come Due

The District conceded that at the time of filing it was paying its debts as they came due. In her declaration filed on the petition date, Casillas states, "[a]s of the date of this Declaration, the District is projected to hold sufficient cash on hand to continue operations without a reduction in services through December 2023, assuming the District makes no further changes to its operations." Casillas Declaration, p. 25:27 – 26:1. The Staff Report, dated May 22, 2023, from Casillas and Robinson to the Board of Directors, further states, "[t]he current cash flow forecast indicates that, while it was cash flow insolvent in November 2022, the short-term stabilization efforts have removed it from qualifying as cash-flow insolvent." Casillas Declaration, Exhibit B, p. 9.

The District argued during trial (and in its closing brief) that it was insolvent on the petition date under § 101(32)(C)(i). It waived that argument by admitting to the contrary. In the interests of completeness, the court will address the District's contention that it is insolvent because it has not paid its current pension contributions and 2021 payroll taxes.

b. The Claimed Pension Expenses are not Supported by the Evidence

The District argues that the CBAs require it to contribute 1.3% of each employee's annual compensation each year to the Defined Benefit Plan, ranging from $3 million in the fiscal year ("FY") 2023 budget, $3.7 million in actuarily determined obligation as of the petition date, to $4.05 million actuarily determined obligations for FY 2023 calculated postpetition. Debtor's Post-Trial Brief (ECF 169), p. 7:8-17. None of these amounts represents the 1.3% mandatory contribution in the CBAs.[7]

[7] The District does not argue that either federal or state law mandates a minimum contribution rate.

To determine how pension contributions figure into the insolvency analysis, one must consider how public pensions in California are funded and the role that actuaries play. In California, a municipality's pension obligation is an amalgam of several factors, including the level of benefits promised, the expenses for administering the retirement system, and the actual returns on system investments. 1 California Public Sector Employment Law § 9.08 (2023). Generally speaking, pension benefits and the expenses associated with them should equal the employer's and employees' contributions and the pension's investment earnings. The trick is trying to estimate the contributions needed today to satisfy the benefits promised to retirees in the future. This is the role of an actuary, who employs a range of assumptions including the size of the workforce, the growth of salaries, changes in payroll, employee mortality, inflation, and investment earnings. *Id.; Cnty. of Orange v. Ass'n of Orange Cnty. Dep. Sheriffs,* 192 Cal. App. 4th 21, 36 (2011). Greater investment returns can result in lower contributions being necessary. 1 California Public Sector Employment Law § 9.08.

Pension fund actuarial analysis relies on several commonly understood terms. The first is a pension's "funded ratio," which is obtained by dividing the pension's actuarial assets by its actuarial liabilities. A pension with a funded ratio below 100% means there is an unfunded liability. *Id.* "Normal cost" is the contribution necessary, when added to investment income, to pay for benefits earned each year. *Id.*; *see also Imperial Cnty. Sheriff's Assn. v. Cnty. of Imperial*, 87 Cal. App. 5th 898, 904 (2023) ("Normal cost is the amount projected to be needed to pay retirement benefits for services rendered by active members for the current year."). The "actuarial accrued liability" is "the difference between the projected normal cost and the actual cost of benefits," as determined at each actuarial valuation. *Imperial Cnty. Sheriff's Assn. v. Cnty. of Imperial*, 87 Cal. App. 5th at 904; 1 California Public Sector Employment Law § 9.08 (2023).

The excess of the actuarial accrued liability over the plan's actuarial assets is the "unfunded actuarial accrued liability" (usually called "UAAL"). This figure represents the promised benefits for which funds have not been set aside. 1 California Public Sector Employment Law § 9.08. The UAAL is not a constant figure, though, as many fluctuating

factors can increase or reduce any potential shortfall. *See Cnty. of Orange v. Ass'n of Orange Cnty. Deputy Sheriffs*, 192 Cal. App. 4th at 35 ("Given the multiple assumptions about the future involved in calculating the [retirement system's] UAAL (investment returns, pay increases, marital status at retirement, retiree and beneficiary life expectancies, salary increases, contribution rates, and inflation), it is clear that the UAAL is a highly variable amount, which may or may not prove accurate depending upon actual future events and experience."). Investments that outperform the actuary's assumed rate of return will reduce the contributions needed to pay down the UAAL.[8] *See City of San Diego v. San Diego City Employees' Ret. Sys.*, 186 Cal. App. 4th 69, 83 (2010) ("[UAAL] occurred over several years and may have been avoided entirely if, for example, the retirement fund experienced better than expected investment returns.").

The important thing to know is that an actuary's recommendation for funding does not represent a legal obligation. "An actuary conveys information and recommendations to a retirement board through reports… The retirement board is the final arbiter or final decision maker of actuarial assumptions… [I]t is the retirement board that, in the exercise of its fiduciary responsibilities, possesses the duty to adopt actuarial assumptions and set contribution rates… It is ultimately up to the retirement board to decide how much to fund the system." 1 California Public Sector Employment Law § 9.08[4].

Under California law, UAALs are not considered current financial obligations. "Most retirement systems have [UAAL]. They arise each time new benefits are added and each time an actuarial loss is realized. [¶] The existence of [UAAL] is not in itself bad, any more than a mortgage on a house is bad. [UAAL] does not represent a debt that is payable today." *Bandt v. Bd. of Ret.*, 136 Cal. App. 4th 140, 157 (2006); *Mijares v. Orange Cnty. Employees' Ret. Sys.*, 32 Cal. App. 5th 316, 325 (2019) ("Employer's [ ] argument fails to acknowledge an Unfunded

[8] "From about 2000 through 2006, the booming stock market resulted in the retirement funds managed by the various retirement systems outperforming the actuarial predictions, and many of them were 'over funded' in the eyes of the members and many administrators—that is, the funds had more money in the retirement accounts than was needed to pay off all of the actuarial liability for all of the promised benefits of workers then employed." 1 California Public Sector Employment Law § 9.11 (2023).

Liability does not represent 'a debt that is payable today.'" (internal citations omitted)). This is supported by how the Governmental Accounting Standards Board ("GASB") treats UAAL, which is considered a long-term liability in financial reports, meaning it will not be due for at least 12 months. T3, 42:21-25; *see also* GASB Statement No. 68.

California courts have addressed whether a UAAL is a debt. *Cnty. of Orange v. Ass'n of Orange Cnty. Deputy Sheriffs*, 192 Cal. App. 4th 21. In 2001, the County of Orange negotiated a new collective bargaining agreement with the union representing its deputy sheriffs. The new agreement increased the amount of pension benefits from 2% of employee earnings per year worked to 3% of employee earnings per year worked. The change was retroactive, so included work that had already been performed in prior years. The county obtained an actuarial report stating this change would increase its "actuarial accrued liability" by approximately $100 million.

In 2008, the county had a "change of heart." It obtained a new actuarial report stating that the cost of the retroactive change in benefits would result in $187 million in additional costs. The county brought a lawsuit in Superior Court to, in effect, terminate the agreement. It contended the provisions in the new contract violated a provision of the California Constitution capping municipal debt. The Superior Court granted a demurrer in favor of the deputy sheriffs, which the Court of Appeals affirmed.

The Court of Appeals, placing heavy reliance on an opinion from the Attorney General's office, held that "an 'unfunded liability' is simply a projection made by actuaries based upon assumptions regarding future events. No basis for any legally enforceable obligation arises until the events occur and when they do the amount of liability will be based on actual experience rather than the projections. While actuarial evaluations do not create legally binding obligations, they do provide useful guidance in determining the contributions necessary to fund a pension system." *Id.* at 36. The court concluded the UAAL was nothing more than "an actuarial estimate projecting the impact of a change in a benefit plan, rather than a legally enforceable obligation…" *Id.* at 36–37.

The line between the 1.3% required contribution and the actuarily determined contribution was not clarified at trial. Two things appear to be true, though. First, 1.3% is not the correct contribution percentage for the District. The CBAs do not require the District to cover the full 1.3% contribution. Rather, the applicable provision states that "the District shall contribute an amount sufficient, *in combination with any required employee contributions*, to fund a benefit equal to one and three tenths percent (1.3%) of the employee's annual compensation in each calendar year."[9] (emphasis added). "Annual compensation" is defined in the CBA as the employee's base pay.[10] So, this obligation is shared with employees.

Second, the 1.3% figure (even assuming it was the accurate percentage) yields an expense that is far less than $4.05 million for FY 2023. Working in reverse, the District would need a payroll of more than $311.5 million[11] to owe anything like those amounts, especially when the Unions represent only about 80% of employees and the 1.3% is of base pay only. The facts show that in 2023 the District budgeted for $67.7 million in salaries and wages. The audited financial reports show salaries and wages expenses of $56.8 million in 2022 and $51.7 million in 2021.[12]

The record indicates, instead, that the $4.05 million obligation for 2023 and $4.1 million for 2024 are simply the District's actuarially determined contributions, broken down as follows:

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[9] NUHW CBA, p. 23, Exhibit B to the Declaration of Mario E. Quintana in Support of Debtor's Motion to Reject Collective Bargaining Agreements, Docket No. 46.

[10] *Id.*

[11] $4,050,000 is 1.3% of $311.5 Million.

[12] The 2022 audited financial statements show a "covered employee payroll" of $24,420,350 for the Defined Benefit Plan. If this is the total compensation (base pay) of participating employees, as defined in the CBA, then 1.3% of $24,420,350 would be $317,465, before deducting the employee contributions.

Actuarially Determined Contributions Before Freeze Amendment[13]		
	2023 Plan Year	**2024 Plan Year (estimate)**
Normal Cost	$1,900,000	$1,960,000
Amortization	$2,250,000	$2,250,000
Expected Employee Contri.	$(230,000)	$(240,000)
Interest	$130,000	$130,000
Annual Actuarially Determined Contribution	$4,050,000	$4,100,000

The trial witnesses agreed that the District does not need to pay the full actuarially calculated amount. Lewis testified that "[t]he actuarially determined contribution is a recommendation and a target." T4, 62:22-23. The District's CFO, Robinson, testified that "[t]he District historically has not funded the additional amount that Nicolay has suggested we fund in order to catch up with the long-term funding liability" and that "[i]t's a guide to funding the plan. We fund the plan according to our ability to fund the plan at any point in time." T2, 180:21-23; T3, 29:5-7. *See In re Hamilton Creek Metro. Dist.*, 143 F.3d at 1386. ("under a cash-flow analysis of insolvency, obligations that are enforceable only on a cash-flow basis cannot, by definition, render a debtor insolvent.").

The District's argument also ignores investment earnings. Robinson testified that "[f]or funding that's been earned, and the biggest factor for that shift year to year is how the market performs. So even in the year where the District doesn't add additional funding, the amount can go up, which it has in the past, and of course, conversely, if there was a year the District put in additional funding, the amount could change in the negative, depending on the stock market." T3, 42:12-19. The consequence being "[e]ven if you are a hundred percent funded one year, you could be underfunded the next year." T2, 180:14-15.

The importance of investment earnings is borne out by the historical figures, which explains why neither CNA nor NUHW is concerned about underfunding in contributions from the District.

[13] Debtor's Exhibit 68.

Audited Financial Statements[14]					
	2018	**2019**	**2020**	**2021**	**2022**
Net Investment Income	$2,501,498	$(1,151,908)	$4,845,847	$3,575,885	$4,315,008
UAAL[15]	$11,967,953	$13,464,962	$12,855,495	$12,243,918	$14,706,676
Funded Ratio	65%	65%	70%	74%	74%
Actuarially Determined Contributions	$3,424,794	$3,486,828	$3,577,595	$3,545,809	$3,438,240
Actual Contributions	$2,396,244	$3,933,677	$1,306,536	$2,702,669	$2,738,385
Contribution Deficiency (Excess)	$1,028,550	$(446,849)	$2,271,059	$843,140	$699,855

From 2018 through 2022, the District only made a contribution to the Defined Benefit Plan above the actuarially determined contribution once (2019), when the investment return was negative. The biggest contribution deficiency occurred in 2020, when the Defined Benefit Plan had more than $4.8 million in investment income. Despite the $2.2 million deficiency, the funded ratio increased 5% from 2019 to 2020. Likewise, the funded ratio improved to 74% in 2021 and 2022 despite the contribution deficiency in those years.

In sum, the District has no legal obligation to pay the actuarially determined contributions, which are neither presently, unconditionally owing, nor presently enforceable. To the extent the CBAs require a mandatory contribution of 1.3% of employees' annual compensation (base pay) each year, minus required employee contributions, none of the parties provided evidence of what that amount is.

c. The Failure to Pay the Deferred Taxes Does Not Constitute Generally Not Paying Debts

The notices sent by the IRS to the District, dated October 24, 2022, show that the deferred payments for the employer's share of Social Security tax for most of 2020 was due

[14] Joint Exhibits J2 – J5 and NUHW Exhibit B38.

[15] Recorded as long-term pension liabilities in the balance sheet.

on December 31, 2022, in the total amount of $1,143,961.[16] IRS sent another notice to the District, dated May 22, 2023, showing that the Social Security tax for the period of September 30, 2020, was not paid and interest in the amount of $10,516.78 and penalty in the amount of $38,098.21 were added to the original amount of $380,982.06, for a total amount due of $429,597.05.[17] IRS filed an amended claim in this case on September 14, 2023, showing a total claim of $1,289,306.88, comprised of taxes owed for the aforementioned tax periods in the amount of $1,143,960.84, interest in the amount of $30,949.94, and penalty in the amount of $114,396.10. These payroll taxes qualify as a debt that is due because it is presently owing and enforceable.

But § 101(32)(C)(i) does not require the payment of *every debt*. "[S]ection 101(32)(C)(i) requires *general* nonpayment of debts as they become due." *In re Boise Cnty.*, 465 B.R. at 171 (emphasis in original). In involuntary cases, for example, a petitioner must show that "the debtor is *generally* not paying such debtor's debts as such debts become due …" 11 U.S.C. § 303(h)(1) (emphasis added). This test is almost identical to the one in § 101(32)(C)(i); *see In re City of Stockton*, 493 B.R. at 788 (relying in interpretations of § 303 in the context of municipal bankruptcies).

The Ninth Circuit has adopted a "totality of the circumstances" test for cases examining the limits of § 303(h)(1). *In re Vortex Fishing Sys., Inc.*, 277 F.3d 1057, 1072 (9th Cir. 2002). A finding that a debtor is generally not paying its debts "requires a more general showing of the debtor's financial condition and debt structure than merely establishing the existence of a few unpaid debts." *In re Dill*, 731 F.2d 629, 632 (9th Cir. 1984).

The payroll taxes were due on December 31, 2022. The 2022 audited financial statements show that the District had total operating expenses of $147.3 million, so the taxes represent 0.77% of the expenses for FY 2022. The FY 2023 budget estimated $158.1 million in operating expenses, so even adding in the penalties and interest, the tax claim of $1,289,306 filed by the IRS constitutes only 0.81% of the operating expenses in the FY 2023

[16] Debtor's Exhibit 22.

[17] Debtor's Exhibit 29.

budget. At the end of April 2023, the District's Cash Flow Statement shows $12.1 million in cash on hand, and B. Riley's numbers show $8,006,349 in cash. The court recognizes, and the evidence is undisputed, that the District was in a dire financial situation at the end of 2022, and not paying the payroll taxes at that time was one of the many cash-saving measures it took to stabilize its finances. But the District's cash flow has steadily improved since the beginning of 2023, with sufficient cash on hand since March 2023 to pay this debt. As Judge Myers noted, "the [debtor's] failure to process and pay a single category of claims, which represents only a small portion of its budgeted expenditures, from what appear to be adequate funds does not rise to the level of the general nonpayment contemplated by § 101(32)(C)(i)." *In re Boise Cnty.*, 465 B.R. at 171. The same can be said here.[18]

2. Sec. 101(32)(C)(ii) – Ability to Pay Debts as They Come Due

Section 101(32)(C)(ii) mandates a solvency test that is performed prospectively and is near-term focused. *See In re City of Stockton*, 493 B.R. at 789 (looking to projections to complete the current fiscal year); *In re City of Bridgeport*, 129 B.R. 332, 338 (Bankr. D. Conn. 1991) (applying the test to the municipality's "current fiscal year or, based on an adopted budget, in its next fiscal year."). "Under this test, insolvency is analyzed on a cash-flow basis." *In re Hamilton Creek Metro. Dist.*, 143 F.3d at 1386; *see also In re City of Vallejo*, 408 B.R. at 289–90 ("insolvency under § 101(32)(C)(ii) is determined on a cash flow basis"); *In re City of Bridgeport*, 129 B.R. at 337 (concluding that the prospective test "should be judged by a cash flow, not a budget deficiency, analysis.").

According to the Tenth Circuit, the test considers obligations that are not speculative. "[I]nability to pay under § 101(32)(C)(ii) depends upon the inescapable quality of the obligation and the certainty that it cannot be met. Mere possibility or even speculative

[18] As of end of April 2023, the District had 28.7 days of cash on hand, which is below the bond covenant threshold of 30 days. With a daily operating cost of $422,200, paying the payroll taxes would further reduce the cash on hand to 25.6 days. At the end of May 2023, 8 days after the petition date, the District had 35.48 days of cash on hand, and paying the payroll taxes would reduce the cash on hand to 32.41 days.

probability is not enough. If the maturity of the debt is imminent and the inability to meet it certain, the debtor is unable to meet debts as they mature within the meaning of the statute." *In re Hamilton Creek Metro. Dist.*, 143 F.3d at 1386 (internal quotation marks and citations omitted).

Fox testified that her firm B. Riley was retained by the District to assist with cash flow problems in late 2022. T2, 9:2-8. Her firm prepared the B. Riley Cash Forecast from the District's online banking information, as supplemented by the District's payment records and its estimates of payments it expected to receive for services performed. T2, 10:17-11:12. The B. Riley Cash Forecast includes four months of actual cash flow data (from January through April of 2023) and projections for the remainder of 2023 and the entirety of 2024. It uses a version of a cash basis budgeting.

B. Riley also prepared the San Benito Health Care District dba Hazel Hawkins Memorial Hospital Solvency Analysis as of May 23, 2023 (dated October 30, 2023) ("B. Riley Expert Report"). That report concludes that the District failed the "ability to pay" test in § 101(32)(C)(ii).

The court does not find these two sources are sufficient to meet the District's burden of proof.

a. The Flaws of the B. Riley Cash Forecast

The testimony at trial showed that there are multiple means of evaluating the District's cash position on a going forward basis. The District relied on the customized reports produced by B. Riley to support its conclusion of insolvency, as these figures are included in the Casillas Declaration and reiterated in its post-trial brief. The B. Riley Expert Report also relied on these figures.

The District maintains a financial reporting system, which adheres to Generally Accepted Accounting Principles ("GAAP"), as prescribed by the GASB. For our purpose,

these financial reports generally fall into two categories.[19] First, there are the audited financial statements for each fiscal year. Second, there are monthly financial statements prepared by the District's CFO Robinson for the District's Finance Committee, which includes members of the Board and others, at its regular monthly meetings. T2:180:24-181:6. These GAAP-based financial reports are prepared on an accrual basis, which attempts to match revenues and expenses to the periods they were incurred, rather than on cash receipts and disbursements.[20]

B. Riley concludes the District will run out of cash by the end of 2024, and its factual premise is the B. Riley Cash Forecast. However, B. Riley's customized numbers are far different than the figures in the District's monthly financial reports. Because of this difference, the Objectors contend B. Riley's projection is not reliable. Since the District is relying on the B. Riley Cash Forecast, it has the burden of proving that the numbers and projections in the forecast presents an accurate and reliable portrayal of its finances.

The chart below summarizes the difference in ending cash balances for each month from December 2022[21] to April 2023, between the B. Riley Cash Forecast and the District's monthly financial reports. In these five months of actual data, the cumulative difference in cash between the District's monthly financial reports and the B. Riley Cash Forecast was $15,036,591.

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[19] The court uses the term "financial reports" generally to describe information that is generated by the District's financial reporting system.

[20] *See, e.g.,* Audited Financial Statements, June 30, 2022, Note A, p. 12.

[21] The December cash balance is taken from the beginning cash balance for January 2023.

Ending Cash Balances					
A	B	C	D	E	F
Month Ending	Last Sat. of full week	Diff. (A-B)	**B. Riley's Current Cash**[22]	**District's Financial reports**[23]	Diff. (D-E)
Dec. 31, 2022	Dec. 31, 2022	0 days	$5,724,320	$7,466,037	$(1,741,717)
Jan. 31, 2023	Jan. 28, 2023	3 days	$5,066,342	$9,223,073	$(4,156,731)
Feb. 28, 2023	Feb. 25, 2023	3 days	$5,189,150	$11,432,225	$(6,243,075)
Mar. 31, 2023	Mar. 25, 2023	6 days	$10,642,105	$11,256,358	$(614,253)
Apr. 31, 2023	Apr. 29, 2023	2 days	$9,826,794	$12,107,609	$(2,280,815)

The question is, why? When asked to reconcile these sets of figures at trial, Fox explained that the B. Riley Cash Forecast is simply a cash budgeting tool "used to measure the impact that certain expenses that will be paid in the budgeted period will have on the District's ending cash balance." By contrast, she said, the District's monthly cash flows statements are financial reports prepared under GAAP. T2, 70:20-71:9.

Fox offered two specific reasons why the B. Riley Cash Forecast would differ from the District's monthly financial reports. First, the B. Riley Cash Forecast is not based on a calendar month. Rather it is prepared based on the last full week of the month ending on a Saturday.[24] Fox explained that a monthly forecast based on a calendar month would not have been accurate. T2, p. 68:2-23. Second, unlike the financial reports, which recognize revenue when earned and expenses when incurred, the B. Riley Cash Forecast recognizes revenue when received and expenses when paid. T2, 71:3-9. Thus, an invoice that was received in May but was paid in June would be recorded in May in the District's monthly cash flow statement but in June in the B. Riley Cash Forecast.

[22] Debtor's Exhibit 32.

[23] Joint Exhibits J7 – J11.

[24] For example, if the last day of the month is a Friday, then the cash balance period for that month ends 6 days earlier on the previous Saturday.

As a preliminary matter, it is obviously true that the court is not required to accept GAAP as the sole or presumptively correct method of evaluating the District's insolvency: the court must make its own determination of insolvency after considering all the evidence presented. *See In re Kaypro*, 218 F.3d 1070, 1076 (9th Cir. 2000) ("There is no generally accepted accounting principle for analyzing the insolvency of a company."); *In re Sierra Steel, Inc.*, 96 B.R. 275, 278 (B.A.P. 9th Cir. 1989) ("Requiring application of GAAP would make accountants and the board which promulgate GAAP the arbiters of insolvency questions. Clearly the Code provides that judges should make such decisions."). But GAAP exists to accomplish the objectives of accurately recording, processing, summarizing and reporting financial data. Financial reports prepared in accordance with GAAP and GASB[25] provide a tangible and uniform means for understanding and evaluating financial data as well as reasonable assurance that the financial reporting is reliable. *See In re City of Stockton*, 526 B.R. at 47 n. 23 ("GASB recommendations are advisory but have achieved credibility among auditors and bond raters that leads most state and local governments to comply with them; some jurisdictions make compliance with them mandatory."). As the court noted in the Hurley Order, GAAP-based statements are designed to create financial reports that are accurate and reliable. "Good faith compliance with GAAP will permit professionals who study the firm and understand GAAP to accurately assess the financial condition of the company." *United States v. Ebbers*, 458 F.3d 110, 125 (2d Cir. 2006).

The District's own witnesses provided conflicting testimony about which set of figures better represents the District's financial position. Robinson admitted that the cash balances generated by the District's financial reporting system were reliable, testifying they were "an accurate representation of how much money the District had to pay its bills" in any given month. T3, 7:1-7; 9:24-10:2; 10:25-11:8; 11:22-12:5. He also affirmed that these figures

[25] As stated in GASB Cod. Sec. 2450.104 (Section 2450, paragraph .104): "The primary purpose of a statement of cash flows is to provide relevant information about cash receipts and cash payments of an entity during a period. When used with related disclosures and information in the other financial statements, the information a statement of cash flows provides should help financial report users assess: (a) an entity's ability to generate future net cash flows; [and] (b) its ability to meet its obligations as they come due[.]"

were included in the reports made available to the Board of Directors, and that the Board of Directors relied on the figures "in making operational decisions for the board," including whether to discontinue a service. T3: 7:1-7. Hurley was not surprised by this, testifying that it is "extremely common" to rely on monthly financial reports for operational decisions and is generally an indicator of cash available to pay bills. T3, 9:7-9.

Some of the testimony at trial was perplexing. Fox testified that ending a reporting period on the Saturday of the last full week of a month accurately reflected cash flow, but she did not explain why or how that is more accurate.[26] Hurley testified he was not aware of a methodology that relied on a transaction cut off that varies from zero to six days before the end of the month. T3, 119:24-120:3.

In addition, for December 2022, there is a $1.7 million difference between the B. Riley Cash Forecast and the December financial report. In this instance, as reflected in the table above, the December ending date for the two reports coincide, and this fact undermines a conclusion of a timing difference. With the end-of-month date being the same, Fox suggested that revenue and expenses were recorded on different dates. The court agrees with Hurley's testimony that the difference in recording method of a few days may account for some discrepancy, but not the significant differences shown here. T3, 121:15-24.

What's more, the B. Riley Cash Forecast consistently reports cash balances that are far below the figures in the monthly financial reports. Purely as a matter of logic, if there were timing differences, one would expect them to even out over time. Hurley, T3, 121:15-24. The District presented no evidence that its own financial reports were somehow less reliable than the B. Riley Cash Forecast in determining the cash available.

Hurley summarized the benefits of a GAAP-based financial reporting system. T3, 122:17-124:3. But the point here is that the District is relying on B. Riley's process of

[26] In attempting to explain why B. Riley decided to produce a cash balance statement based on the last full week ending on Saturday in the month, Fox stated, "But to – split it out and to put on a calendar – put it on a calendar basis, I don't know that that necessarily would have been accurate, and I definitely think *it wouldn't have been worth the cost to the District in terms of professional fees*." T2, p. 68:9-13 (emphasis added).

calculating cash that produces a result that is substantially and consistently lower than its own financial reports without adequate explanation and without evidence that the former is more accurate. In fact, the court finds Hurley's criticisms of B. Riley's methods to be well-reasoned and credible.

With a difference of over $15 million for those months with actual data, the court is also concerned about the accuracy of the projection, and the court has no way to confirm the legitimacy of B. Riley's figures.[27] The report reduces income to two very broad categories called "Recurring Revenue" and "Net Supplemental Revenue." The District's operating expenses are reduced to a single line called "Operating Cash Disbursements." By comparison, the audited financial statements have eleven line-items under operating expenses, such as "salaries and wages," "supplies," "utilities and phone," etc. Similarly, revenues are divided into "net patient service revenue," "district tax revenue," "investment income," etc. Without any breakdown of revenues and expenses, the court cannot evaluate R. Riley's figures vis-a-vis the District's own historical numbers and the context of how R. Riley estimated the various figures. *See, e.g., In re Town of Westlake, Tex.*, 211 B.R. 860, 866 (Bankr. N.D. Tex. 1997) (finding Westlake's 1998 budget of $1,408,896 for road repairs "not credible" when it spent only $18,641 on road repairs in 1997 and none in 1995).

In sum, the District has not proven that the B. Riley Cash Forecast presents a sound basis for analyzing the District's cash flow.

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[27] The comparison of May ending cash balances provides a good illustration. The petition was filed on May 23, 2023. For the Riley Cash Forecast, the month of May ended on May 27, 2023, which was the last Saturday of the last full week in May. The parties did not provide evidence of ending cash position with a petition-date cutoff. The Riley Cash Forecast projected an ending cash balance of $8,006,349. The District's monthly financial statement for May shows an ending balance of $14,914,309. Although there are a few postpetition days included in the month, the point is that the Riley Cash Forecast continues to understate the cash balance whereas the District's cash flow statement shows continued improvement.

b. The Flaws of the B. Riley Expert Report

The B. Riley Expert Report is somewhat difficult to follow. It appears to be in the form of a PowerPoint presentation and provides a sort of building block approach to the question of insolvency. For the reasons outlined below, the court does not place great weight on the B. Riley Expert Report.

To begin, the B. Riley Expert Report indicates that the firm has been instructed to make a conclusion on the District's Cash Insolvency and Budget Insolvency. It subdivides that question into several different tests to build to a conclusion. Along the way, it discusses Cash Insolvency Based on Contractual Cash Obligations and Based on Cash, Working Capital and Other Cash Requirements, plus Budget Insolvency.[28] Each waypoint on this journey leads B. Riley to a seemingly inexorable conclusion: the District is insolvent.

To be clear, the test for insolvency is outlined above and it is not broken down into these many categories and sub-categories. The court will analyze the categories B. Riley has used to understand its conclusions, but in doing so it does not intend to adopt or replace the legal standard. This is simply B. Riley's view of how insolvency should be measured.

Cash Flow Insolvency Test

The B. Riley Expert Report presented a cash insolvency test. B. Riley admitted that the starting point for its cash insolvency analysis is the B. Riley Cash Forecast, which the court has already found to be unreliable.[29] B. Riley also considered the actuarily determined contributions to the Defined Benefit Plan as contractual obligations to be accounted for in the cash flow analysis, which is legally incorrect as discussed above. The court finds additional problems.

The financial projection in the cash insolvency test is mixing apples and oranges. The projection uses the B. Riley Cash Forecast as a starting point. To this, B. Riley adds expenses

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[28] These subcategories would appear to be drawn from the bankruptcy court's discussion in *In re City of Stockton*, 493 B.R. 772. It is important to recall the *Stockton* decision relies on cash insolvency to make a finding of insolvency and only considered other categories to ascertain whether, as the objecting parties there claimed, the city was manufacturing its insolvency.

[29] Debtor's Exhibit 38, p. 30.

that are not reported on a cash flow basis, including pensions, seismic retrofitting, and capital improvements. In other words, B. Riley calculated the operating income and expenses using a cash method, and then made numerous adjustments based on some sort of accrual-based system. This method appears intended to capture expenses that might be necessary but are not picked up on a cash basis.

This method is flawed because it is cherry-picking expenses without going through the analysis that accrual basis financial reports rely on for reporting purposes. Stated another way, accrual-based statements are premised on accounting theory. They have precise procedures for when something must be recognized (whether income or expense) and recorded in the financial records, and when something is merely a disclosure item. B. Riley's approach of picking and choosing items that ought to be included without a stated and systematic methodology is not reliable.

An example shows how this analysis has gone wrong. B. Riley added $4,285,714 in expense to the cash flow analysis in 2023 for seismic retrofitting. The District says it requires $30 million to comply with seismic regulations by 2030. The B. Riley Expert Report imagines a "sinking fund" that began in 2018, which would require a cash allocation each year from the budget, which it calculates at $4,285,714 for 2023.[30] This is problematic because no such sinking fund exists; these are purely hypothetical expenses. The District's financial reports show no accrual for this amount.[31]

It is also problematic in view of Hurley's testimony that large capital projects are usually paid for with debt, charitable contributions, or (lastly) internal funds. No one contradicted his testimony. And the District introduced no evidence to show that the only means of funding this expense is internal funds. In any event, it seems likely that the scope

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[30] B. Riley calculated the cash allocation for the sinking fund each year starting from 2018 to 2023. The earlier the fund started, the fewer the cash allocation per year. If the District had started the sinking fund in 2018, it would require only $2,500,000. But the District has not provided any evidence that it even considered the sinking fund until it filed bankruptcy.

[31] The District's actual FY 2023 budget did not include such an expense not because it could not afford it, but because the project is still in the planning stage. T2, 167: 20-22.

and timeline of the 2030 requirements may change, or extensions may be given.[32] The court does not doubt that paying for the seismic compliance will be a tough task, especially for smaller hospitals with limited resources and funding such as the District, but for the purpose of § 101(32)(C)(ii), the obligation to set aside funds now is not "certain" and does not have an "inescapable quality."

Working Capital Test

B. Riley concluded that the District is insolvent under a working capital test. Working capital is a metric that compares a company's current assets to its current liabilities. Current assets are those assets that could be readily reduced to cash (such as cash, accounts receivable, and other items that will be received in a year). Current liabilities are those that will need to be satisfied or paid within a year and include things like accounts payable and the portion of long-term debt due in the coming year. T3, 96:13-97:15.

Hurley testified that as of June 30, 2022, the District's current ratio was 1.52, meaning that it could satisfy financial obligations arising over a period of approximately one and a half years. T3, 103:2-6. The B. Riley Expert Report comes to a different conclusion. It says that the District had a "working capital ratio" of 8%, and a substantial deficiency in working capital. In making that calculation, the B. Riley Expert Report excluded both the District's cash balance of $14.4 million, and its "short term debt." The evidence on this point is at best equivocal. Without more, the court does not conclude that the District will not be able to pay its upcoming obligations.

Days' Cash on Hand

B. Riley analyzed the District's cash holding by measuring "days of cash on hand." It concluded that the District had a cash shortfall of $36.9 million on the date of the bankruptcy filing and was insolvent. Indeed, B. Riley contends the District's failure to satisfy

[32] The first set of seismic requirements had an original deadline of 2008 but that was later pushed back to 2020 if a hospital met certain conditions. *See, generally,* Cal. Health & Safety Code § 130061.5.

this metric, standing alone, requires a finding of insolvency. B. Riley's methodology is speculative and flatly inconsistent with the District's historical experience.

Cash on hand simply represents the amount of cash on deposit divided by daily expenditures. B. Riley prepared a chart entitled Cash on Hand which shows that for every year since 2018, the District has suffered from a cash shortfall ranging from $21.7 million to $38.5 million, based on B. Riley's parameters. To arrive at this figure, B. Riley analyzed the days' cash on hand for all California healthcare districts that operate hospitals, which it found should be at a "normalized" level of 118.3 days.[33] Because the District had only 28.7 days' cash on hand on the petition date, B. Riley concluded: "A cash deficit of $36.9 million[34] in and of itself indicates that the District was INSOLVENT on the Petition Date without consideration of the other analyses and adjustments contained in this report." (emphasis in original).

B. Riley might be right – if the days' cash on hand figure were iron-clad and reliable. But it is not. First, it bears mention that interim CEO Casillas cited a completely different goal of 222.48 days' cash on hand in her declaration, based on the median days' cash on hand for all California critical access hospitals. Casillas Declaration, p. 18:23-23. She seemed to be less certain of her figures, saying at trial: "[T]here's no stated rule of how many days we should have on cash on hand. But we have comfort levels…I would feel more comfortable if we had a hundred days' cash on hand. I'd sleep at night and feel very comfortable if we had over 200 days cash on hand." T1, 28:20 – 29:1. This alone disputes R. Riley's conclusion that anything less than 118.3 days of cash of hand constitutes insolvency under § 101(32)(C)(ii).

The high number B. Riley selected as the required level of days' cash on hand may partly be explained by Jacobson's testimony during the trial, which skewed the analysis

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[33] According to B. Riley, 118.3 days is the median days of cash on hand for all California healthcare districts with hospitals during 2019, before the pandemic, which distorted the cash picture due to extraordinary government funding.

[34] 118 days – 28 days = 90 days x average daily operating costs of $410,000.

toward healthy institutions. He was asked if the $36.9 million shortfall came about because the District fell below an average. He replied,

> It's based on – well, I wouldn't say it's falling below average because … over the period I observed, [the District] was always comfortably below the average.
>
> But in valuation and insolvency, we want a healthy company. And to establish benchmarks for a healthy company, we look at a broader set of data from other industry participants.

T.3, 76:4-10. The analysis required by § 101(32)(C)(ii) does not look for healthy companies, but those that are insolvent.

The District's analysis on this point is not properly supported. The District has never had anything like 118.3 days' (let alone 222.48 days') cash on hand. Taking B. Riley's suggested figure of 118.3 days as the "normalized" level separating insolvent hospital districts from solvent ones, the District has been insolvent every year since 2017 (the earliest data that was presented at trial).[35] Historically, the District's days' cash on hand has been low due to its small size, and its status as a stand-alone health system that cannot provide a full range of services, such as cardiology and neurology. T2, 179:8-22.

Moreover, the source of the 118.3 figure is somewhat hazy. The B. Riley Expert Report indicates that the figure was from analyzing days' cash on hand "at *all* California healthcare districts that operate hospitals."[36] (emphasis added). But in his testimony, Jacobson indicated that the sample size was from *twenty* California healthcare districts that were "*sufficiently similar*" to the District. T3, 56:19-24. The evidence conflicts as to the data set that was the source for the 118.3 figure; the record does not clarify this point.

B. Riley's 118.3 days' figure is impossible to square with CNA's expert Hurley. He testified that in his forty years of experience, he had come to rely on the Almanac of Hospital Financial and Operating Indicators to assess appropriate levels of days' cash on hand. That publication was not ideal either because it ceased publication in 2017. But it was

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[35] Under B. Riley's standard of cash-on-hand insolvency, nine out of the twenty hospital districts that B. Riley analyzed would also qualify for chapter 9 under § 101(32)(C)(ii).

[36] Debtor's Exhibit 38, p. 22.

comprehensive and included data from approximately 4,000 hospitals nationwide. Based on hospitals with revenues that were comparable to the District's, the median value for 2017 (the last year data was available) was 59.8 days of cash on hand.

Finally, the District's independent auditors would have been surprised to know the District had been insolvent every year since 2017. The audited financial statements presented to the court all indicated that "[t]he Hospital maintains sufficient cash and cash equivalent balances to pay all short-term liabilities."[37]

The District failed to present a coherent theory to show the appropriate number of days of cash on hand for the District.

For these reasons, the court does not find the B. Riley Expert Report to be a reliable source of information for determining insolvency and discounts its conclusions accordingly.

III. CONCLUSION

For the foregoing reasons, the court sustains the objections of CNA and NUHW and finds that the District has not met its burden of proving it was eligible to be a debtor under chapter 9. This case is DISMISSED pursuant to § 921(c).

Because the court concludes the District failed to show it is insolvent under § 109(c)(3), it does not need to address NUHW's argument that the District's petition should be dismissed because it was not filed in good faith.

IT IS SO ORDERED.

*** END OF ORDER ***

[37] According to the audited financial statements, the District had the following days of cash on hand at the end of each fiscal year: 32.25 for FY 2017, 24.37 for FY 2018, 45.84 for FY 2019, 65.06 for FY 2020, 49.12 for FY 2021, and 37.07 for FY 2022.

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

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