IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

In re: SUN HEALTHCARE GROUP, INC., *et al.* Debtors.	Chapter 11 Bankruptcy Case No. 99-3657 through 99-3841 (MFW) (Jointly Administered)
HEALTH CARE FINANCING ADMINISTRATION, Appellant, v. SUN HEALTHCARE GROUP, INC., Appellee.	Civil Action Nos. 00-986-GMS

MEMORANDUM AND ORDER

I. INTRODUCTION

On October 14, 1999, Sun Healthcare Group, Inc. ("Sun Health") and certain of its subsidiaries (collectively, "the debtors") filed a petition for Chapter 11 bankruptcy in the United States Bankruptcy Court for the District of Delaware ("the Bankruptcy Court"). Prior to the bankruptcy, the debtors operated health care facilities across the nation. These facilities participated in both the Medicare and Medicaid health care programs. Consequently, they were required to comply with all state and federal regulations regarding these programs.

Prior to the petition, one of Sun Health's subsidiaries, SunBridge Care and Rehabilitation University ("University") of Illinois, was suspended from participation in both the Medicare and Medicaid programs for failure to comply with regulations. University was told that it could be reinstated if it cured the violations. University met all compliance conditions and applied for

reinstatement. However, before University could cure its Medicaid obligations, Sun Health filed for bankruptcy, thus triggering the automatic stay provisions of the Bankruptcy Code.

On September 20, 2000, the debtors filed a motion in the Bankruptcy Court for an order pursuant to sections 105(a) and 525(a) of the Bankruptcy Code compelling the Health Care Financing Administration ("HCFA")[1] of the United States Department of Health and Human Services to: (i) recertify the SunBridge Care and Rehabilitation University ("University") for participation in the Medicare program or (ii) authorize the Debtors to pay prepetition debts owed to HCFA in connection with University. The debtors alleged that by requiring the them to pay the pre-petition debt to HCFA, the government had unfairly discriminated against a debtor in violation of section 525 which prohibits the government from denying licences and other governmental grants "solely because" a person is a debtor. 11 U.S.C. § 525.

The Bankruptcy Court, by the Honorable Mary F. Walwrath, held a hearing on the motion on October 26, 2000 and concluded that the Medicaid provider agreement was a license for the purposes of section 525. The Bankruptcy Court further found that by conditioning University's recertification upon the repayment of pre-petition debt, HCFA unfairly discriminated in violation of section 525(a). In a written order issued that same day, the Bankruptcy Court ordered recertification as requested by University. HCFA promptly appealed the Bankruptcy Court's order on November 2, 2000.

On appeal, HCFA contends that the Bankruptcy Court erroneously found that: (1) the

[1] In 2001, HCFA was renamed the Centers for Medicare and Medicaid Services. The court will use the prior name because it was in effect during the events relevant to this appeal.

Medicare provider agreement was a "license" under section 525 and (2) HCFA unfairly discriminated against University based solely upon its status as a debtor. HCFA contends that the Medicaid provider agreements are more akin to executory contracts. Thus, HCFA asserts the monies owed by University and non-dischargeable debts falling outside the protection of section 525. HCFA further argues that there was no unfair discrimination because both debtors and non-debtors alike must pay existing debts before they can be reinstated in the Medicaid program.

The debtors respond that section 525 is not limited to licenses, but comprises licenses, permits, charters, and "other such grants." *Id*. The debtors maintain that the Medicaid provider agreements are licenses, but that even if they are not, they are similar enough to be considered "other such grants." Additionally, the debtors maintain that there is discrimination because they have complied with the HCFA's requests in all other ways except for the monetary payments. This, they claim, amounts to discrimination because, given its bankrupt condition, University cannot pay the pre-petition debt without permission of the Bankruptcy Court.

Upon review of the facts, the law, and parties' submissions, the court finds that the Medicaid provider agreements constitute licences or "other such grants" within the meaning of section 525. Additionally, the court finds that under these circumstances, HCFA's actions were discriminatory within the meaning of section 525. The court will now explain the reasons for its decision.

II. FACTS

University, a subsidiary of Sun Health, is a skilled nursing facility in Edwardsville, Illinois. University participates in both the Medicare and Medicaid programs. The Medicaid program requires the participating providers to be subject to both state and federal laws and regulations.

On May 6, 1999, HCFA terminated the participation of University in the Medicare and

Medicaid programs. The termination was based upon HCFA's determination that University had failed to comply with the applicable quality of care requirements for the Medicare program for more than six months. In addition, HCFA imposed a civil monetary penalty of more than $60,000 upon University for failure to meet the standards. HCFA also contends that University owes $133,648 as a result of overpayments made for the 1998 fiscal year.

Sun Health filed an administrative appeal of the termination and penalty decision.[2] [3] In a stipulation of settlement dated May 17, 1999, Sun agreed to withdraw its appeal and HCFA reduced the outstanding monetary penalty to $44,395. The settlement also indicated that University was required to pass two reasonable assurance surveys performed by the Illinois Department of Public Health before it could apply for reinstatement in the Medicaid and Medicare programs. The settlement also indicated that University was required to pay the penalty within twenty days after the effective date of the settlement. The settlement terms make no mention of how any overpayments might be paid, and does not condition the settlement upon the payment of those debts.

On October 6, 1999, University passed its first reasonable assurance survey. The second survey was conducted on January 14, 2000. University also passed this inspection. Nevertheless, between the two inspections, on October 14, 1999, Sun Health and its affiliates, including University, filed for Chapter 11 bankruptcy in the Bankruptcy Court. The debtors remain in possession of the business and continue to operate the various facilities. The estate has not been

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[2] Sun Health also filed a lawsuit in the United States District Court for the Southern District of Illinois which sought an injunction against the termination. However, the court dismissed the case for lack of jurisdiction.

[3] The record is not clear on exactly where Sun Health filed this administrative appeal. Nevertheless, because the appeal is ultimately not essential to the case at bar, the court will not devote an inordinate amount of time to discovering the answer to this mystery.

liquidated at this point.

On May 10, 2000, after the debtors filed for bankruptcy, HCFA wrote to University and confirmed that it was "in compliance with all requirements for a skilled nursing facility and that the deficiencies which led to the previous termination had been corrected." (D.I. 11 at Ex. A.) The letter further stated that there was reasonable assurance to believe that the reasons for the previous termination would not recur. (*Id*.) However, the letter concluded that despite these assurances, University would not be reinstated. The letter stated that the applicable regulation, 42 C.F.R. 489.57, required that a new provider agreement could not be issued until the provider has fulfilled, or made satisfactory arrangements to fulfill, all of the statutory and regulatory responsibilities of its previous agreement. (*See id.*) The letter continued to state that "based on the existence of two outstanding debts to the Medicare program, the provider has not fulfilled, nor made satisfactory arrangements to fulfill, all of the statutory and regulatory responsibilities of its previous provider agreement." (*Id*.)

The letter then referenced the $133,648 overpayment and the $44,395 civil penalty. HCFA then noted that "[u]ntil and unless these two financial obligations are met, we find that [University] does not meet the requirements for entry into the Medicare program." (*Id.*) The letter concluded by asking University to provide certification of its solvency in addition to repaying the outstanding debts.

On September 20, 2000, Sun Health filed a motion in the Bankruptcy Court for an order pursuant to sections 105(a) and 525(a) of the Bankruptcy Code compelling HCFA to either: (i) recertify University for participation in the Medicare program; or (ii) authorize the Debtors to pay prepetition debts owed to HCFA in connection with University. A hearing was held on the motion on October 26, 2000. After hearing argument, Judge Walwrath orally ruled as follows:

> With respect to the substance of the motion then, I believe it is insufficient to argue that this is a contract and therefore not a license. I believe that licenses and the other types of items included in Section 525 are merely a subset of contracts. With respect to whether or not this contract is a licence, I find that it is a license. It's not a good argument that the debtor requires other licenses in order to operate. If we look at the fundamental nature of the agreement between HCFA and the debtor, it's clear that it is a license being issued by the government to permit the debtor to participate in a program, and although it has financial aspects of it, I think those are clearly ancillary to the primary purpose of the program which is to license or authorize qualified parties to participate in the a program with the Government whereby the government agency will enter into contracts with those properly certified or licensed by the government.
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> And finally, I find that the refusal to decertify is clearly discriminatory under Section 525 because it is solely for failure to pay a prepetition debt. And I think that by the strict language of Section 525 [that] is prohibited. So I will grant the debtors' motion and direct the Government to decertify.

(D.I. 7 at A-32.)

The Bankruptcy Court issued a written order granting Sun Health and University's motion that same day. The Government promptly filed its appeal in this court on November 2, 2000.

III. STANDARD OF REVIEW

In reviewing a case on appeal, the Bankruptcy Court's factual determinations will not be set aside unless they are clearly erroneous. *See Mellon Bank, N.A. v. Metro Comm., Inc.*, 945 F.2d 635, 641 (3d Cir. 1991), *cert. denied*, 503 U.S. 937, (1992). A Bankruptcy Court's conclusions of law are subject to plenary review. *See Metro Comm., Inc.*, 945 F.2d at 641. Mixed questions of law and fact are subject to a "mixed standard of review." *See id*. at 641-42. Under this "mixed standard of review," the appellate court accepts findings of "historical or narrative facts unless clearly erroneous, but exercise[s] plenary review of the trial court's choice and interpretation of legal precepts and its application of those precepts to historical facts." *Id*.

IV. DISCUSSION

Section 525 of the Bankruptcy Code states, in pertinent part:

> [A] governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, deny employment to, terminate the employment of, or discriminate with respect to employment against, a person that is or has been a debtor under this title . . . solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or debtor under the Bankruptcy Act . . . or has not paid a debt that is dischargeable in the case under this title or that was discharged under the Bankruptcy Act.

11 U.S.C. § 525. Thus, in order to invoke the protection of section 525, at minimum, a debtor must be able to demonstrate that there is a governmental "license permit, charter, franchise, or other similar grant" involved, and must then prove that this license has been interfered with solely because of the debtors' bankrupt status.

The court will first discuss whether the Medicaid provider agreement is a license or "other similar grant" for section 525 purposes. The court will then address whether HCFA discriminated against the debtor in violation of section 525.

A. The Medicaid Provider Agreement is a License or "Other Similar Grant"

There is very little case law addressing exactly what constitutes a license under section 525. Even fewer courts have addressed whether Medicare provider agreements are licenses for the purposes of this section. The Third Circuit has never addressed the issue. However, HCFA argues, *inter alia*, that in *In re University Medical Center,* 973 F.2d 1065, 1075-76 (3d Cir. 1992), the Third Circuit held that Medicaid contracts were similar to executory contracts. HCFA contends that since contracts are not covered in section 525, the provider agreements at issue should not be covered under that section.

The court disagrees with HCFA for several reasons. First, in *University Medical*, the court

was focused on whether the provider agreement at issue was assignable under section 365 of the Bankruptcy Code. *See id.* at 1075. The issue under section 525 was at best tangential to the Third Circuit's decision. However, it is telling that even in this tangential discussion, the Third Circuit declined to state that the Medicare provider agreement was not subject to the provisions of section 525. Moreover, the district court in *University Medical*, which also found that section 525 was inapplicable in light of the facts presented, also declined to state that Medicare and Medicaid provider agreements could never fall within the purview of section 525. *See University Medical Center v. Sullivan*, 122 B.R. 919, 924 (E.D. Pa. 1990). Indeed, the Government has not cited, and the court has not found, any case wherein a court has explicitly stated that Medicare and Medicaid agreements are *prima facie* exempt from the requirements of section 525. Conversely, several courts have found that section 525 *is* applicable to Medicare agreements, and have applied its provisions accordingly. *See In re Psychotherapy and Counseling Center, Inc.*, 195 B.R. 522, 529-530 (Bankr. D.D.C. 1996) (applying section 525 in Medicare and Medicaid contexts); *In re St. Mary's Hospital*, 89 B.R. 503, 504 (Bankr. E.D. Pa. 1988) (applying section 525 to Medicare agreement). Since neither the Third Circuit nor the Supreme Court have expressly forbid this court from applying section 525 in the Medicare context, the court will follow the rationale of the cases that have done so. Thus, the court finds that even if *University Medical* correctly found that Medicare provider agreements are not *per se* licenses, they may still fall under the purview of section 525.

Aside from its executory contract argument, HCFA also contends that the Medicare provider agreement is not a license because the actual facilities are licensed by the individual states in which

they operate. In its brief on appeal, HCFA stated, "The only difference between a facility with a Medicare provider agreement and one without is that the former will be reimbursed by Medicare for services properly rendered to medicare beneficiaries at the facility. Although it is true that without a provider agreement a facility cannot be reimbursed for services rendered to medicare beneficiaries, the same can be said for every Federal contract." (D.I. 6 at 11.) The court rejects this argument as well.

In *In re Watts*, 876 F.2d 1090 (3d Cir. 1989), the Third Circuit stated, "Indeed, it seems perfectly clear that the items enumerated [in Section 525] are in the nature of indicia of authority from a governmental unit to the authorized person to pursue some endeavor." *Id*. at 1094. The court finds that the Medicare provider agreements at issue authorized the providers to pursue an endeavor, namely caring for elderly patients. The language quoted from the Government's brief proves that by the Government's own admission, entering into the provider agreement allows the provider to enter into this endeavor and receive a governmental benefit - namely reimbursement. Although HCFA argues that hypothetically, it is possible for a provider to care for Medicare patients in the absence of a provider agreement, without the agreement, they would receive no compensation for the services. Consequently, without a provider agreement, providers would be forced to provide Medicare services free of charge. Thus, although the Government's argument proves that, in theory, a provider does not require a Medicare provider "license" to participate in the Medicare program, HCFA has never successfully refuted the argument that without the provider agreement, the providers will lose the governmental benefit of compensation for their services. Therefore, the court finds although the Medicare provider agreement may not be a license in the strictest sense of the

word, it is clearly similar to a license for section 525 purposes.[4] [5]

B. HCFA Engaged in Discrimination under section 525

The second question the court must answer is whether HCFA discriminated against University in its termination decision. Actually, this is a two part question because the debt in question must be dischargeable before discrimination can be found. *See* 11 U.S.C. § 525. To that end, the court will first address whether the debt at issue is dischargeable. The court will then discuss why it finds that HCFA discriminated in the case at bar.

1. Was the debt at issue dischargeable?

In order to provide debtors with a fresh start, the Bankruptcy Code discharges many of the

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[4] Although the HCFA argues that such a holding will open the floodgates to making section 525 applicable to any type of governmental agreement, the court disagrees. The court trusts that its colleagues on the bankruptcy, district, and appellate courts will be able to faithfully implement the Congressional intent expressed in section 525. The court finds HCFA's arguments regarding benefits to the elderly versus benefits to providers to be similarly unavailing in this context and will not address that argument in this opinion.

[5] HCFA also argues that since the governmental entities must rely on the financial soundness of the providers, the Medicare provider agreements are similar to loans, and therefore section 525 is inapplicable. The Third Circuit case relied on by HCFA for this proposition, *In re Watts*, held that a loan agreement did not fall within the scope of section 525. *See Watts*, 876 F.2d at 1090-91. The court feels that HCFA's argument overstates the significance of financial security in the Medicare context. In *Watts*, where loans were involved, financial soundness was a paramount concern, *see id.* at 1091, and with good reason. By contrast, although a provider's financial condition may be somewhat relevant to the medical services provided, the Government has failed to demonstrate that any of the applicable regulations dictate that a provider's creditworthiness is a primary or paramount concern when issuing a Medicare provider agreement. Thus, *Watts* is distinguishable and the court rejects HCFA's argument on this point.

debtor's prior obligations upon the completion of the bankruptcy. The extent of the discharge depends in large part on the type of debtor involved. The discharge of debts for Chapter 11 corporate debtors such as Sun Health is governed by 11 U.S.C. § 1141. Section 1141 states that upon confirmation of the debtor's plan, all debts shall be discharged, with a few exceptions. The exceptions state that the debt shall not be discharged if the estate is completely liquidated, if the debtor does not continue to operate its business, or if the discharge would not be permitted under section 727 of a Chapter 7 bankruptcy. *See* 11 U.S.C. § 1141. In turn, chapter 727 contains numerous conditions under which a debt may not be discharged, most revolving around bad faith or fraud on the part of the debtor. *See* 11 U.S.C. § 727.

After reviewing the salient provisions of the Bankruptcy Code, the court is convinced that both the overpayments and the civil penalties are completely dischargeable under section 1141. First, the debtors' estate has not been liquidated at this point. Second, as required by section 1141, the debtors continue to operate their health care business. Although HCFA contends that the debt is not dischargeable if the debtor plans to continue in business, in fact, according to section 1141, the debt will only be dischargeable *if* the debtors remain in business. Thus, HCFA's argument to the contrary is unavailing. Finally, neither University nor Sun have engaged in conduct proscribed by section 727 that would render the debt non-dischargeable. The court can find no support in the Bankruptcy Code for the proposition that the debts at issue cannot be discharged. Case law lends further support to the court's position. Both *In re Psychotherapy Centers* and *In re St. Mary's* implicitly held that debts similar to the one at bar were dischargeable. *See In re Psychotherapy Centers*, 195 B.R. at 525-526 (monetary penalty for fraudulent claims excused under section 525); *In re St. Mary's*, 89 B.R. at 504 (overpayments excused pursuant to section 525). For these reasons, the court finds that the debts at issue are fully dischargeable.

2. HCFA engaged in prohibited discrimination under section 525

Section 525 states that government units may not discriminate against a debtor "solely because" the debtor is or has been a debtor under the Bankruptcy Act. *See* 11 U.S.C. § 525. HCFA contends that it did not discriminate *solely* because of University's bankruptcy. Rather, it contends that it had other legitimate, non-bankruptcy, reasons for failing to reinstate University's license. The court disagrees.

The case primarily relied on by HCFA, *University Medical*, addressed this issue. In reversing the bankruptcy court below, which had held that discrimination occurred, the Eastern District of Pennsylvania stated:

> It may be true in the government-contract and public-housing cases that the government did not treat the bankrupt debtors differently from debtors who had not filed in bankruptcy, but were in similar financial trouble. Yet the government did treat the bankruptcy debtors differently from contractors and tenants who were not in bankruptcy and not eligible to file. It is this type of dissimilar treatment that section 525(a) was designed to prohibit, and this type of dissimilar treatment that appears to be missing in the case at bar.

University Medical Center v. Sullivan, 122 B.R. 919, 924 (E.D. Pa. 1990). Thus, although the Eastern District failed to find discrimination on the facts before it, it also specifically realized that the possibility of discrimination might exist where the government treats debtors differently from their solvent counterparts.

Applying the rationale of *University Medical* to the present case, it is clear that University has complied with HCFA's dictates in all respects except for the payment of the fees and penalties. The court is aware that the applicable Medicare regulations state that all providers must return any overpayments to the applicable governing body. *See* 42 C.F.R. § 405.371. The court is further

aware that the regulations also require a provider to reconcile all prior debts before reinstatement. *See* 42 C.F.R. § 489.57. HCFA contends that these regulations are implemented evenhandedly, without regard to the provider's financial status. Despite these reassurances of fairness, the court finds that HCFA's failure to reinstate University in light of its indebtedness is discriminatory for two reasons.

First, although HCFA contends that it is treating University as it would any solvent entity, the court notes that unlike a solvent entity, University cannot pay the debt at this time. To be certain, if the debt at issue was non-dischargeable for some reason, the court would of course require University to pay it. However, the fact that this debt is dischargeable means that it is patently unfair to require University to pay it as a condition to its reinstatement. In other words, the discharge of the debt means that HCFA will not receive any money after the debtors' plan is confirmed, and will not get the money it desires in any event. Thus, University should not be required to pay HCFA money to which it is not entitled as a result of University's bankruptcy. HCFA's actions are therefore discriminatory for the reasons outlined in *University Medical*, because a solvent provider could never find itself in this position.

Second, the court also finds that there is discrimination because although University has provided reasonable assurance that its health services will meet HCFA regulations, HCFA is conditioning reinstatement not on University's inadequate care, but rather on its failure to pay its debts. The court is wary of finding that this is acceptable. The *rasion d'etre* of a health care provider is to provide medical services. If HCFA refused to reinstate University because it believed

that it could not provide adequate medical care, it would be well within its rights. However, HCFA's focus on University's financial condition to the exclusion of other factors favoring its reinstatement raises an inference of discriminatory treatment. Although a solvent entity would not be affected by such a focus, the consequences for a bankruptcy debtor could be disastrous. The court finds that such treatment flies in the face of the "fresh start" policy the Bankruptcy Code was intended to promote.

Finally, the court notes that HCFA states that it must implement all regulations fairly. In support of its position, HCFA cites *In re James,* 198 B.R. 885 (Bankr. W.D. Pa. 1996), wherein the court held that a public housing tenant who challenged her eviction for failure to pay rent was not eligible for the protection of section 525 because it would be unfair to others waiting for public housing and to other rent-paying tenants. *See id.* at 889. The court held that allowing the debtor to skirt her rent obligations would "pervert § 525(a) by turning it into a sword rather than a shield." *Id*. However, the court finds that *James* is not controlling in this case. In *James*, the debtor was evicted solely because of her financial mismanagement. Since tenants must pay rent, it would not have been fair for her to continue to live in the apartment without paying rent of some sort. Conversely, in the present case, the termination of the provider agreement was not a direct or indirect result of the debtor's financial irresponsibility. If this were the case, the court would decline to find discrimination. Rather, the agreement was terminated for University's failure to comply with the applicable health care standards. The fact that money was not a motivating factor in the original termination of the provider agreement, but it becomes an issue at the reinstatement phase, gives rise to an inference of discrimination. In the absence of any rationale to connect the repayments to the quality of medical service, the court finds that requiring payments of dischargeable debts is discriminatory under the Bankruptcy Code.

V. CONCLUSION

In sum, the court finds that the Bankruptcy Court correctly decided that the provider agreement at issue was a license or similar grant for the purposes of section 525. The court further finds that the lower court correctly decided that HCFA impermissibly discriminated against the debtor in violation of section 525 by conditioning reinstatement in the provider plan upon the payment of a dischargeable debt. Therefore, the court will affirm the Bankruptcy Court's October 26, 2000 order in all respects.

NOW, THEREFORE, IT IS HEREBY ORDERED that:

1. The October 26, 2000 decision of the Bankruptcy Court which granted the debtors' motion pursuant to section 525(a) of the Bankruptcy Code is hereby AFFIRMED.
2. The Appellant's associated "Motion for Appeal" (D.I. 6) is DENIED.
3. The Clerk shall close this case.

Dated: September 4, 2002

Gregory M. Sleet
UNITED STATES DISTRICT JUDGE