IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE
NORTHERN DIVISION

IN RE:

MEDEX REGIONAL LABORATORIES, LLC

Case No. 03-31932
Chapter 11

Debtor

NOTICE OF APPEAL FILED: March 29, 2004

DISTRICT COURT NO.:

DISPOSITION:

MEMORANDUM OPINION

March 18, 2004

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE
NORTHERN DIVISION

IN RE:	:	
	:	
MEDEX REGIONAL	:	Case No. 03-31932
LABORATORIES, LLC	:	Chapter 11
	:	
Debtor	:	

BEFORE THE HONORABLE RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE

APPEARANCES:

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THE COURT: Before the court are two contested matters: the Motion for Appointment of a Trustee filed by the Unsecured Creditors Committee on January 5, 2004, and the Amended Motion to Sell MedEx Regional Laboratories, LLC Operating Assets Free and Clear of Liens and Interests and for Approval of Bid Procedures with Assumption of Laboratory Services Agreement and Related Leases filed by the Debtor on March 9, 2004. Four objections to the sale motion were filed on February 20, 2004. Two of the objections, those filed by the Committee of Unsecured Creditors and Carilion Consolidated Laboratories, remain under consideration.

Both matters were consolidated for trial on March 16, 2004. The record before the court consists of thirty-two exhibits introduced into evidence, along with the testimony of six witnesses: Eddie George, President and Chief Executive Officer of Wellmont Health System; Edward Bush, Executive Vice President of the Debtor; Dr. Marcus Grimes, a physician with Holston Valley Hospital and former Chairman of the Debtor's Board of Governors; Richard Ray, the Debtor's Chief Financial Officer; Rayburn Thompson, Executive Vice President of Carilion Consolidated Laboratories; and Matthew Bolton, Sr., the Chairman of the Creditors' Committee.

This is a core proceeding. 28 U.S.C.A. § 157(b)(2)(A), (N), and (O) (West 1993).

The Debtor filed the Voluntary Petition commencing its Chapter 11 bankruptcy case on April 8, 2003, and since that date, it has continued to operate as a debtor-in-possession. The Debtor provides laboratory services to hospitals, physicians, and other health care groups primarily in upper East Tennessee. It was formed in October 1999 as a joint venture between a group of pathologists and Wellmont Health System. At the time it was formed, each group was a 50% owner of the interests, with the right to appoint one-half of the members of the Board of

Governors. On April 9, 2003, the date after the Chapter 11 petition was filed, Wellmont acquired the 50% interest held by the pathologists, thus making it the 100% owner of the Debtor.

The Debtor and Wellmont Health System are also parties to a Laboratory Services Agreement, effective as of October 1, 1999, and continuing through December 31, 2002, with automatic one-year renewals unless terminated 180 days prior to December 31st, or by June 30th of that year. Under the terms of the Laboratory Services Agreement, the Debtor receives referrals from Wellmont of the majority of its laboratory services, providing the Debtor with a large percentage of its revenues. Additionally, the Debtor currently leases its business premises from Wellmont pursuant to various Lease Agreements.

On August 6, 2003, the Debtor filed a motion requesting an extension of the exclusivity period in which it could file a plan of reorganization, which was heard on August 28, 2003. The court entered an Order extending the exclusivity period through October 6, 2003, but the Debtor did not a file a plan, nor has any other party to date.

Instead, the Debtor proposes to liquidate its assets through a sale under § 363 of the Bankruptcy Code under the following terms, and I will summarize these loosely and briefly. The Debtor proposes to sell all of its operating assets, with the exception of its bank accounts, certain claims against other entities, and any liquidated damages it may later realize. The Debtor contemplates offering three bid packages: (1) its outreach business only; (2) all operating assets other than the outreach business; and (3) all operating assets. Prospective bidders will be required to execute a confidentiality agreement prior to receiving limited due diligence information with additional due diligence information to be provided after the court approves and enters

the order authorizing the sale. Afterwards, the prospective bidders may submit proposed schedules of the operating assets to be included in their bids. The Debtor and the Creditors' Committee will then submit drafts of the bid packages and draft standard and nonstandard purchase contracts for each package, and prospective bidders may request changes thereto. Thereafter, the Debtor and the Committee will distribute final bid packages and contract forms. Two days prior to the auction of the Debtor's assets, currently proposed for April 28, 2004, all bid packages and contracts must be submitted, and only qualified bidders will be permitted to bid at the auction. The sale will then be subject to approval by the court and must be sufficient to satisfy certain prepetition secured claims.

Within three days of closing, the Debtor will distribute the net proceeds of the sale in the following order of priority: (a) funding of a "Bank Claim Escrow," consisting of the secured claims of First Tennessee Bank and SunTrust Bank for the value of encumbered assets included in the sale; (b) funding of a "Committee Expense Escrow," consisting of up to $100,000.00 for reimbursement to the Committee for expenses related to the Committee's support and promotion of the sale; (c) payment of all remaining net proceeds to Wellmont Health Management Services, LLC, the postpetition lender, until the postpetition debtor-in-possession financing is paid in full; and (d) any excess funds will be general assets of the bankruptcy estate, subject to distribution under the Bankruptcy Code.

Under the Motion for a § 363 Sale, the Debtor has also included a provision that any purchaser of bid package (2) or (3) will be required to assume and perform the Laboratory Services Agreement with Wellmont, at least through December 31, 2004. Likewise, any purchaser of bid package (2) or (3) will also be required to assume and perform the Debtor's leases with Wellmont through

December 31, 2004. Wellmont has made an initial offer to purchase Bid Package (3) for $4,000,000.00.

The Committee's Motion for Appointment of a Trustee and its objection to the Motion for a § 363 Sale are both primarily based on the fact that Wellmont, either directly or indirectly, has 100% ownership and control over the Debtor, which has suffered substantial losses since it filed for Chapter 11. Moreover, the Committee avers that there is a patent conflict of interest based upon the lack of any arm's-length negotiations between the Debtor and Wellmont in their pre- and postpetition dealings. The Committee also argues that the Debtor's Motion for a § 363 Sale was filed solely to allow Wellmont to acquire the Debtor's assets at a low purchase price, after leading other interested parties to believe that the Debtor was working toward filing a plan of reorganization. Additionally, the Committee does not agree that a sale is justified, as it believes a plan of reorganization would better serve all parties. Finally, the Committee does not approve of the proposed bidding procedures in the Motion for a § 363 Sale, which the Committee argues are tailored to serve Wellmont's interests and do not lend themselves to competitive bidding.

The Debtor opposes the Motion for a Trustee, arguing that the efforts of its present management have taken the more than $1,000,000.00 in operating losses during the first twenty days of the Chapter 11 to an average of $120,000.00 per month for the last three months of 2003. Moreover, the Debtor argues that it has finally started to realize a profit once again, as reflected in its February 29, 2004 monthly operating report, evidencing the company's net income of $8,096.00. *See* TRIAL EXHIBIT 16. Additionally, the Debtor discounts its relationships with Wellmont, arguing that there is no conflict of interest between the two entities, and that it would not be in any party's best interest to appoint a trustee.

Similarly, the Debtor argues that there are two principal justifications for selling its assets through a § 363 sale. The first is the potential for the Debtor to lose market share in providing medical laboratory services in the area while in bankruptcy; i.e., the longer it is in bankruptcy, the more clients it is apt to lose. The second justification is that Wellmont cannot be assured that the Debtor will be able to confirm a plan of reorganization prior to the expiration of the Laboratory Services Agreement on December 31, 2004, which may be terminated by Wellmont on June 30, 2004, and which would cause the value of the Debtor's business to significantly decrease. Additionally, in support of its revised bid procedures, the Debtor argues that it has created a situation where no bid is excluded and whereby the prospective purchaser will no longer be required to assume all leases and executory contracts of the Debtor. Finally, although it must maintain strict guidelines concerning the dissemination of its due diligence information in order to protect its interest, the Debtor has reiterated that this information is ready once potential bidders execute the required confidentiality agreement.

Pursuant to 11 U.S.C. §§ 1101, 1107, and 1108, a Chapter 11 debtor generally operates as debtor-in-possession, and as such, is responsible for maintaining property of the estate, filing monthly operating reports, and continuing with operation of the debtor's business, without the necessity to appoint a trustee. *See also In re Microwave Products of America, Inc.*, 102 B.R. 666, 670 ("Inasmuch as chapter 11 is designed to give the debtor an opportunity to rehabilitate through reorganization, the Bankruptcy Code favors allowing the debtor to remain in possession and operate the business."). Nevertheless, the court may appoint a Chapter 11 trustee pursuant to 11 U.S.C. § 1104, which provides in material part:

(a) At any time after the commencement of the case but before

> confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—
>
> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
>
> (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

In Chapter 11 cases, a trustee is not appointed unless a party in interest demonstrates that such appointment is necessary and appropriate; i.e., "when the debtor in possession fails to adequately perform the duties of a trustee [and] . . . fails to protect and conserve property of the estate for the benefit of its creditors [which] . . . diminish[es] the value of the estate as a whole." *Sumitomo Trust & Banking Company, Limited v. Holly's, Inc. (In re Holly's, Inc.)*, 140 B.R. 643, 685. The appointment of a trustee is an extraordinary remedy, and the party seeking appointment must prove one of the statutory bases by clear and convincing evidence. *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 471. Several factors must be explored, because the appointment of a trustee is, in essence, the replacement of a debtor's management, which creates costs to the estate in the form of a statutory trustee fee and the transition costs that are "implicit in replacing current management

with a team that is less familiar with the debtor specifically and its market generally." *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 577. "Nevertheless, in the appropriate case, the appointment of a trustee is a power which is critical for the Court to exercise in order to preserve the integrity of the bankruptcy process and to insure that the interest of creditors are served." *In re Intercat, Inc.*, 247 B.R. 911, 920.

"[A]ppointment of a trustee is mandatory upon a finding of cause under subsection (1) or upon a finding that a trustee would serve the interests outlined in subsection (2), [but] the decision to appoint a trustee still falls within the court's discretion[, and the] determination of 'cause' under subsection (1) is within the court's discretion[, based on the facts presented]." *Official Committee of Asbestos Claimants v. G-I Holdings Inc. (In re G-I Holdings Inc.)*, 295 B.R. 502, 507. The statutory list of what constitutes "cause" is not exhaustive, and the court may consider both prepetition and postpetition conduct. *Microwave Products*, 102 B.R. at 671. Traditionally, factors used to determine whether appointment of a Chapter 11 trustee is in the best interests of creditors include (1) the debtor's trustworthiness; (2) the debtor's past and present performance and its prospects for rehabilitation; (3) confidence of the business community and the debtor's creditors in the debtor's present management; and (4) if the benefits of appointing a trustee outweigh the costs associated therewith. *In re Madison Management Group, Inc.*, 137 B.R. 275, 282.

> In addition to Section 1104(a)(1)'s enumerated examples of conduct constituting cause – fraud, dishonesty, incompetence or gross mismanagement – courts have found cause to appoint a trustee based on the following factors: (1) materiality of the misconduct; (2) evenhandedness or lack of same in dealings

> with insiders or affiliated entities vis-a-vis other creditors or customers; (3) the existence of pre-petition voidable preferences or fraudulent transfers; (4) unwillingness or inability of management to pursue estate causes of action; (5) conflicts of interest on the part of management interfering with its ability to fulfill fiduciary duties to the debtor; [and] (6) self-dealing by management or waste or squandering of corporate assets.

In re SunCruz Casinos, LLC, 298 B.R. 821, 830.

In support of its Motion for a Trustee, the Creditors' Committee avers that because Wellmont is essentially in control of the Debtor, there are inherent conflicts of interest prohibiting arm's-length negotiations between these parties. Therefore, the Committee believes that it would be in the best interest of creditors for the Debtor to operate under the control of a Chapter 11 trustee, who can then make an objective determination whether a sale of the Debtor's assets or a plan of reorganization would better benefit all parties.

On the other side, the Debtor argues that the appointment of a trustee is neither appropriate nor necessary, as it has continued operation of the medical laboratory services business, has timely filed all monthly operating reports, has timely paid all statutory fees, has reduced its monthly expenses, and has reduced its pre-petition debt. The Debtor takes issue with the Committee's arguments that there is a conflict of interest with Wellmont. While the Debtor admits that Wellmont owns a 100% interest in the Debtor, in one form or another, it reiterates that they are two wholly separate legal entities, having separate locations, separate boards of directors or governors, separate management, separate accounting systems, separate bank accounts, separate assets and liabilities, and separate legal counsel. The Debtor avers

that there are no instances where its relationship with Wellmont has resulted in any detriment to the Debtor, its creditors, or any other interested party. Instead, the Debtor maintains that without Wellmont's assistance, the Debtor would not be in the better financial position that it now enjoys.

Finally, the Debtor argues that it would not be in the best interest of creditors to appoint a trustee. The Debtor asserts that the only benefit to be gained from the appointment of a trustee alleged by the Committee is that there will then be an arm's-length negotiation between the Debtor and Wellmont for laboratory services under the Laboratory Services Agreement. The Debtor argues that a trustee would be in no better position to negotiate an extension of the Agreement than would be the Debtor's current management. Similarly, the added expenses associated with the appointment of a trustee, including administrative expenses to the bankruptcy estate, would far outweigh any benefit to be derived therefrom. There would also be a delay in the transition, possibly costing the Debtor the ability to sell its assets to currently interested companies and potential bidders.

Pursuant to § 1104(a), the court must determine whether cause exists to justify the appointment of a trustee, or if doing so is in the best interest of creditors. The Committee has urged the court to find that cause exists based upon the many relationships between the Debtor and Wellmont, and in support thereof, it offered the testimony of Mr. George, who is the President and Chief Executive Officer of Wellmont and Secretary of the Debtor's Board of Governors. The Committee also offered the testimony of Mr. Bush, who serves as the Debtor's Executive Vice President and reports directly to Mr. George and Mr. Ed Ollie, Wellmont's Chief Financial Officer, in their capacity as members of the Debtor's Board of Governors. The Committee also offered the testimony of Mr. Ray, who is the Debtor's Chief

Financial Officer, who reports generally to the Debtor's Board of Governors but reports directly to Mr. Bush.

"The mere fact that a party occupies dual roles as an owner and a creditor in a bankruptcy case is clearly insufficient to establish cause for the appointment of a trustee." *SunCruz Casinos*, 298 B.R. at 832. However, the duty of loyalty expected from a debtor-in-possession includes a duty not to engage in self-dealing, meaning that as a fiduciary, a debtor-in-possession is prohibited from "acting solely in its self interest to the exclusion of the other interests which the debtor-in-possession has the fiduciary obligation to protect." *In re Bellevue Place Associates*, 171 B.R. 615, 624. "'[C]ause' under . . . § 1104(a)(1) may emerge from a wide variety of factual scenarios [and] would include, presumably, a breach of fiduciary duty owed by the debtor to creditors[.]" *Official Committee of Asbestos Personal Injury Claimants v. Sealed Air Corp. (In re R.W. Grace & Co.)*, 285 B.R. 148, 158.

It is undisputed that Wellmont holds and controls, both directly and indirectly, a 100% interest in the Debtor. Based upon the evidence before it, the court finds six distinct relationships between the Debtor and Wellmont that, taken together, give considerable concern:

(1) Wellmont appoints or elects every member of the Debtor's Board of Governors and, in fact, the five members of the Debtor's Board have a direct connection with Wellmont. Two officers of Wellmont, Mr. Ollie, Wellmont's Chief Financial Officer, and Mr. George, Wellmont's President and Chief Executive Officer, are on the Debtor's Board of Governors, with Mr. George also serving as Secretary of the Debtor's Board. Two members of the Debtor's Board of Governors are also members of the Wellmont Board of Directors, and the final member of the Debtor's Board of Governors is also a member of the Board of Directors for

Wellmont Holston Valley Medical Center.

(2) Wellmont is the Debtor's largest customer, accounting for approximately 75% of the Debtor's total business. In connection with this relationship, the Debtor and Wellmont are parties to the Laboratory Services Agreement.

(3) Wellmont is one of the Debtor's largest prepetition creditors, having claims exceeding $2,000,000.00.

(4) Wellmont provides computer and technical support to the Debtor.

(5) Wellmont is the Debtor's landlord for its primary laboratory space and other locations. There are currently nine leases between the Debtor and Wellmont, whereby the Debtor makes monthly payments to Wellmont totaling $64,039.36. See Trial Exhibit 29 setting forth the details of these leases.

(6) Wellmont Health Management Services, LLC, which is controlled entirely by Wellmont, is the Debtor's postpetition lender, and is now owed more than $5,600,000.00 by the Debtor for this lending.

At trial, Mr. George testified that he did not believe that these relationships between the Debtor and Wellmont give rise to a conflict of interest between the two entities. The court disagrees. The proof establishes to my satisfaction that the Debtor cannot sufficiently be separated from Wellmont for the Debtor's best interests to be served without regard to Wellmont's interests, and this justifies the appointment of a trustee for cause.

The Wellmont Health System Consolidated Financial Statements dated June 30, 2003 and 2002 with Report of Independent Auditors, marked as Trial Exhibit 1, refers to a joint venture with the Debtor. In particular, Note 7 to the Notes to Consolidated Financial Statements is entitled "Loss on Investment in Medex" and provides, in material part:

> From October 1999 through April 9, 2003, Wellmont had a 50% ownership interest in Medex . . . a provider of outpatient laboratory services to Wellmont, other nonaffiliated hospitals and various physician practices.
>
> . . . .
>
> On April 9, 2003, Wellmont acquired the other 50% ownership interest in Medex. As a result, Wellmont now owns 100% of the outstanding membership interest in Medex.
>
> . . . .
>
> Medex has continued to incur losses post-petition, which will require Wellmont to continue to record 100% of Medex's losses.
>
> . . . .
>
> On November 4, 2003, Wellmont's Board of Directors authorized a purchase offer for Medex of up to $8,500,000.00.

See TRIAL EXHIBIT 1.

On January 23, 2004, the Debtor's Board of Governors held a meeting at which they unanimously authorized and recommended that the Debtor file its Motion for a § 363 Sale. Additionally, the Board of Governors recommended to Wellmont that it make an initial offer of $4,000,000.00 in that § 363 sale, which is incorporated within the sale Motion. Mr. George testified that this figure was based solely on the September 15, 2003 appraisal given by Kirk A. Rebane of Haverford Healthcare Advisors, valuing the Debtor's assets at $3,000,000.00 and did not include the aggregate amount of claims filed, any figures from the Debtor's monthly operatingreports, or consideration of any potential third-party purchasers. Likewise, there was no bargaining for this amount; Wellmont merely accepted the figure

provided by the Debtor and proceeded accordingly.

These actions by an independent Board of Governors, in and of themselves, would not give rise to any concern; however, the court must take into account additional circumstances that do present a great deal of concern. As previously stated, the Debtor's Board of Governors is not independent: there are individuals serving on the Board that are also members of the Wellmont Board. These individuals knew, in January 2004, that Wellmont was authorized to purchase the Debtor's assets in an amount up to $8,500,000.00, which Mr. George acknowledged at trial. Additionally, Mr. Ray, who has extensively reviewed the claims filed in the bankruptcy case, testified that if the initial $4,000,000.00 bid price at a § 363 sale ends up being the actual purchase price of the Debtor's assets, unsecured creditors will receive no distribution whatsoever, because the purchase price must be at least $7,000,000.00 to cover all claims taking priority over unsecured creditors as set forth in the Amended Motion.

An additional factor to be considered is the customer relationship between the Debtor and Wellmont, as more specifically set forth in the Laboratory Services Agreement. Under the terms of the Laboratory Services Agreement, the Debtor agreed to provide laboratory services to all Wellmont-affiliated hospitals and physicians, with fees to be paid pursuant to the fee schedule attached to the Agreement. After January 1, 2001, the Debtor could negotiate reasonable adjustments to the fee schedule following notice to Wellmont on January 1st of that year. Pursuant to the terms of the Laboratory Services Agreement, Wellmont agreed to refer all laboratory services to the Debtor, with limited exceptions, including laboratory services that Wellmont itself provided, such as point-of-patient services and those necessary for emergency procedures. The Laboratory Services Agreement also

provides that it may be terminated by either party, to be effective on December 31st, provided that the terminating party gives written notice to the other party on or before June 30th of that same year.

Although the Laboratory Services Agreement seems to favor Wellmont, all parties agree that it is in the Debtor's best interests for the Laboratory Services Agreement to remain in effect. If the Laboratory Services Agreement is terminated, the Debtor, or any subsequent purchaser of its assets, will lose approximately 75% of its total business, 60% from the hospital business and 15% of its outreach business. In fact, Mr. Ray testified that the Debtor does not control the Laboratory Services Agreement, and if Wellmont terminates it, the Debtor would be unable to continue realizing any profits. Nevertheless, Mr. George testified that Wellmont had every right to terminate the Agreement, regardless of what impact it might have on the Debtor. While there is nothing improper about that statement or Wellmont making a decision to terminate the Agreement, the statement does indicate to the court where Mr. George's primary loyalties lie. This is pertinent not because Mr. George is the President and Chief Executive Officer of Wellmont but because he is a voting member of the Debtor's Board of Governors, and in that capacity, he is required to do what is in the Debtor's best interest, not Wellmont's. With regards to the Laboratory Services Agreement, these interests are not necessarily the same.

Moreover, there is some question as to whether Wellmont has already decided to terminate the Laboratory Services Agreement, calling into question the good faith of the members of the Debtor's Board of Governors in authorizing a § 363 sale prior to June 30, 2004. When questioned at trial regarding termination of the Agreement, Mr. George testified that no decision has been made at this time. Additionally, Mr. Ray testified that the Debtor has not been notified, as required by

the Agreement itself, that Wellmont will terminate. However, on cross-examination, Mr. Ray conceded that he has been told by Mr. George that Wellmont does anticipate terminating the Agreement by June 30, 2004.

Additionally, the September 15, 2003 appraisal is based upon an assumption that Wellmont will terminate the Agreement. Trial Exhibit 15 is a November 10, 2003 letter to Gary D. Miller, as Senior Vice President and General Counsel for Wellmont, from the appraiser, Mr. Rebane, setting forth a valuation summary of the appraisal. This letter states, in material part:

> It is our considered opinion that the fair market value of a 100 percent controlling interest in the [Medex] Laboratory, as of September 15, 2003, is $3,000,000, subject to the assumptions, extraordinary assumption, hypothetical conditions, and jurisdictional exceptions delineated later in this value-reporting letter.
>
> The basis of value which was utilized in our appraisal was fair market value, which is defined . . . as the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.
>
> It should be noted that this valuation has been conducted based on certain key assumptions, extraordinary assumptions, hypothetical conditions, and jurisdictional exceptions, . . . including, but not limited to, the following:
>
> > As a hypothetical condition and extraordinary assumption, it has been assumed that the Laboratory Services Agreement

> . . . between Medex and Wellmont, dated October 1, 1999, will expire on December 31, 2004, effectively converting Medex solely into an outreach laboratory at that point in time. The advisors and management of Medex and the advisors and management of Wellmont . . . have advised Haverford Healthcare Advisors that the Agreement will expire on December 31, 2004 based on the status of the Agreement as of September 15, 2003; hence, you have asked us to value [Medex] as if such a termination will indeed occur.
>
> . . . .
>
> During the course of our analysis, we relied on information provided by you, [Medex], your accountants, attorneys, and other representatives, and other sources.

See TRIAL EXHIBIT 15. Mr. George testified that he did not instruct the appraiser to make this assumption and that he did not know why the assumption was made; however, from the face of the letter itself, it appears that Mr. Rebane was expressly informed by some party with both the Debtor and Wellmont that the Agreement would be terminated in 2004.

Other evidence leading the court to believe that the Debtor has not always operated in its own best interests, but in favor of Wellmont's best interests, includes the lack of billing adjustments over the past three years. Despite the fact that, under the Laboratory Services Agreement, the Debtor was authorized to negotiate price adjustments beginning in January 2001, it has not. To the contrary, Mr. Bush testified that the Debtor has never assigned anyone to review the Wellmont pricing to

determine if any adjustments were needed. Instead, the Debtor has reduced its number of labs, reduced its employee base, rejected some of its leases and executory contracts, and has found other ways to cut costs. Mr. Bush testified that he recently began looking at pricing, and that the Debtor has instituted price increases for new tests not covered by the Laboratory Services Agreement, but at this time, the Debtor has not made or requested any adjustments to the Wellmont pricing. Similarly, Mr. Ray testified that he has not researched what competitors charge their clients vis-a-vis what the Debtor charges Wellmont. It is suspect that during a time of severe financial distress, both prior to and after the Debtor's April 8, 2003 bankruptcy filing, the Debtor has made no attempts to increase its revenues by seeking an adjustment of its prices with Wellmont, who has provided the bulk of its revenues over this time period.

The court also believes that the circumstances surrounding the Debtor's proposed § 363 sale evidence its undivided loyalty to Wellmont, at the expense of its own best interests and those of its creditors. Instead, the Debtor appears to have fashioned a sale whereby Wellmont would be able to purchase the Debtor's assets, terminate the Laboratory Services Agreement, and begin running its own labs which are already set up and running, without missing a beat and without having to worry about any serious possibilities of an outside third party coming in.

It seems as though throughout its Chapter 11 case, the Debtor has led the Committee and other parties in interest to believe that it was in the process of proposing a plan of reorganization. On August 6, 2003, the Debtor filed its motion requesting an extension of the exclusivity period, which the court granted after a hearing on August 28, 2003. The motion was filed one day after the major parties and their counsel attended a meeting on August 5, 2003, at which there was no

mention of the possibility that the Debtor was contemplating a § 363 sale. Additionally, the Chairman of the Creditors' Committee, Mr. Bolton, testified that until recently, the Committee believed the Debtor was working on a plan because representatives of the Debtor and/or Wellmont have alluded to a plan. Specifically, Mr. Bolton testified that he was told by Mr. Ray that Mr. George was pulling together information to prepare a plan.

When questioned at trial as to why the Debtor did not propose a § 363 sale in the fall of 2003, Mr. Ray testified that the timing was not right, that the company was not stable, and that it needed to be stronger before offering its assets for sale. He also testified that, at that time, the Debtor was only interested in trying to survive and become a profitable company. It wanted to obtain additional investments, evaluate its assets, and make changes to its existing equipment and information technology.

Despite the fact that the Debtor cannot effectuate a § 363 sale without court approval, both the Debtor and Wellmont seem particularly optimistic that such a sale will take place, and the court is satisfied that Wellmont has postured itself to be the purchaser. Mr. George testified that the Debtor is not working on a plan of reorganization because it believes that a § 363 sale will move the process forward more quickly and because approval of a plan would most likely occur after the June 30, 2004 deadline for terminating the Laboratory Services Agreement. Mr. George also testified that Wellmont does not have a contingency plan in the event that a third party purchases the Debtor's equipment at a § 363 sale, despite the fact that both he and Dr. Grimes testified that it would take many months to set up a new permanent lab. Likewise, Mr. Bush testified that development of a lab takes between six and seven months. In support of this assessment, he introduced a chart prepared by the Debtor's compliance officer detailing this process. *See* TRIAL EXHIBIT 9.

Mr. George also testified that Wellmont would be required to set up mobile labs to be in effect on January 1st in order to maintain continuous laboratory services during a transfer of ownership of the permanent equipment to a third party, at a cost of substantially more than $4,000,000.00. Again, it is bothersome that the Debtor and Wellmont seem to be so well-assured that a § 363 sale will be approved and that Wellmont will be the final purchaser. As far as the court is concerned, these assumptions are particularly troublesome in light of the testimony of Mr. George, Mr. Bush, and Mr. Ray that Wellmont's first concern is the ability to provide continued services to its patients, yet they have taken no steps to that end in the event that the sale is not approved or a third party purchases the Debtor's assets. The testimony of these gentlemen regarding the catastrophic effect a loss of lab services would have on patient care and hospitals in the event the Debtor is unable to sell its assets by June 30, 2004 termination date rings hollow because it is apparent that Wellmont has set itself up to be the purchaser of the Debtor's assets.

The court's determination is further buttressed by testimony regarding the interest of third parties in purchasing the Debtor's assets prior to the Debtor's Motion for a § 363 Sale that was expressly ignored. Mr. Bush testified that there have been at least seven labs that have expressed an interest in purchasing some or all of the Debtor's operating assets since it filed for Chapter 11 on April 8, 2003, although, presently only five are still interested. Nevertheless, the Debtor did not pursue a § 363 sale at that time, nor did the Debtor take steps to propose a plan of reorganization that would allow for the sale of its assets.

Carilion Consolidated Laboratories is one party interested in purchasing the Debtor's assets. Its Executive Vice President, Mr. Thompson, testified that Carilion first expressed an interest in purchasing the Debtor's assets to Mr. Ollie, Chief

Financial Officer for Wellmont, in June 2003, and at that time, he was told that the Debtor was not interested in selling its assets. For his part, Mr. George testified that he first became aware that Carilion was interested in purchasing the Debtor's assets sometime in the fall of 2003.

On January 8, 2004, after meeting with representatives of the Debtor, Mr. Thompson testified that the Debtor's confidentiality agreement was executed on behalf of Carilion, who then expected to receive due diligence information. Nevertheless, Mr. Thompson testified that Carilion was not provided due diligence information, nor has it received any such information from the Debtor, despite repeated written and verbal requests for this information.

After making written inquiries to Mr. George in January 2004, Mr. Thompson testified that during a telephone conversation with Mr. George in February 2004 regarding the potential purchase of the Debtors' assets, Mr. George informed him that it was not in Wellmont's interests to have any other entity running its labs. At trial, Mr. George reiterated that it was not likely that Wellmont would want any other entity running its labs.

All of this evidence, taken together, provides the necessary cause to justify the appointment of a Chapter 11 trustee. The Debtor's current management appears to have difficulty operating outside of Wellmont's best interests. Moreover, the Debtor's Board of Governors, which is appointed by Wellmont, is made up of officers and members of the Board of Directors of Wellmont, who are primarily concerned with what best suits Wellmont. There are inherent conflicts of interest, as evidenced by the testimony of Mr. George, Mr. Bush, and Mr. Ray, and the court agrees that it must direct the appointment of a trustee to provide the Debtor with an objective governing body. Having found that cause exists to appoint a trustee, the court is mandated by the

Bankruptcy Code to do so.

Next at issue is the Debtor's Motion for a § 363 Sale. Section 363(b)(1) of the Bankruptcy Code authorizes a bankruptcy court to permit the sale of a debtor's assets "other than in the ordinary course of business." *See Stephens Industries, Inc. v. McClung*, 789 F.2d 386, 388. The bankruptcy court has the discretion to determine whether it should permit a sale pursuant to § 363; however, the debtor maintains the burden of establishing whether a § 363 sale is warranted. *See Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1062, 1071.

"[A] bankruptcy court can authorize a sale of all a Chapter 11 debtor's assets under section 363(b)(1) when a sound business purpose dictates such action." *Stephens Industries*, 789 F.2d at 390. In deciding whether a sound business purpose exists, the court should "act to further the diverse interests of the debtor, creditors and equity holders, alike." *Stephens Industries*, 789 F.2d at 389 (quoting *Lionel Corp.*, 722 F.2d at 1071). Accordingly, a motion for a section 363 sale should be denied if the interests of all parties are not considered and/or not furthered by the sale. In *Stephens Industries*, the Sixth Circuit adopted the reasoning set forth by the Second Circuit in *Lionel Corp.*, as follows:

> In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike. He might, for example, look to such relevant factors as the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will

> be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value. This list is not intended to be exclusive, but merely to provide guidance to the bankruptcy judge.

Stephens Industries, 789 F.2d at 389 (quoting *Lionel Corp.*, 722 F.2d at 1071). However,

> [f]actors such as: 1) the proportionate value of the asset to the estate as a whole; 2) the effect of the proposed disposition on future plans of reorganization; 3) which of the alternatives of use, sale or lese, the proposal envisions; and 4) the likelihood that a plan of reorganization will be proposed and confirmed in the near future are not significant where it is apparent that the proposed sale will have the effect of a total liquidation of the debtor's assets.

In re Oneida Lake Development, Inc., 114 B.R. 352, 355 (Bankr. N.D.N.Y. 1990).

The proof before the court in the present case does not establish that a § 363 sale is necessarily warranted. Just over eleven (11) months have elapsed since the time of the Debtor's filing. The Debtor's Monthly Operating Report dated January 31, 2004, reflects that the Debtor has lost money each month, but the losses are decreasing in magnitude. *See* TRIAL EXHIBIT 12. Further, the Debtor says it expects to have a monthly net income, rather than a loss, through December 2004.

See TRIAL EXHIBITS 17 and 18. The Debtor, or a third party, may be able to successfully reorganize the Debtor's business. The operating assets the Debtor proposes to sell are not decreasing in value, and the Debtor projects net income through December 2004.

The Debtor relies upon the $3,000,000.00 appraisal value of its assets. This appraisal is as of September 15, 2003, a date when the postpetition accounts receivables were $500,000.00 less than as of January 31, 2004. The appraisal does not include prepetition accounts receivable. The appraisal also assumes that the Laboratory Services Agreement between Wellmont and the Debtor will be terminated. More than 50% of the Debtor's revenues under the Laboratory Services Agreement are denoted as "Inpatient" revenue. An appraisal is only one of several factors and is generally not the controlling factor examined by the courts in determining value. Further, whether the operating assets are sold at the appraised value or at Wellmont's $4,000,000.00 offer, the party in interest who is helped is Wellmont. Unsecured creditors will not receive any portion of the sale proceeds unless the sale price exceeds approximately $7,000,000.00. As has previously been discussed, however, it seems clear that if the § 363 sale as presently proposed by the Debtor is allowed, Wellmont will likely be the primary beneficiary, and unsecured creditors will receive nothing.

While it is true that funds realized from a § 363 sale may possibly benefit the Committee by lessening Wellmont's interest in the remaining assets, such as avoidance actions and a pending action against the Debtor's managers and governors, any recovery the Committee or the Debtor may realize from those actions is not certain, but is contingent and dependent on a number of circumstances; whereas funds realized by the Debtor as an operating entity are, as established by the monthly increase in revenues, much more likely to be realized and to benefit all parties.

Accordingly, the diverse interests of the Debtor, creditors, and equity holders alike cannot presently be furthered by the § 363 sale proposed by the Debtor.

The Debtor asserts it is faced with the prospect of losing business because customers and creditors are fearful it may not undergo a successful reorganization. However, the Debtor's revenues are not decreasing; rather, since the Debtor's Chapter 11 filing, its revenues have been fairly steady and are increasing.

What gives the court the greatest concern, as has already been expressed, is that Wellmont appears to have dictated every step of the Debtor's bankruptcy, with little or no regard to the interest of any other party. Wellmont and the Debtor are so intertwined that the court must question whether the Debtor has proposed the § 363 sale in good faith which is an additional requirement for any sale under § 363 of the Bankruptcy Code. *See*, for example, *In re Mallory Co., Inc.*, 214 B.R. 834, 836. Wellmont, by itself or through the Debtor, has telegraphed its intent to cancel its Laboratory Services Agreement with the Debtor; has lulled the Committee and prospective purchasers into believing a plan of reorganization will be filed without, in fact, ever intending to file one; and has waited until shortly before the June 30, 2004 Laboratory Services Agreement Notice Termination date to file the § 363 Motion. The court seriously questions the Debtor/Wellmont's good faith in proposing the sale.

Finally, note 7 to the audit report of Wellmont's independent auditors recites that on November 4, 2003, Wellmont's Board of Directors authorized a purchase offer for the Debtor of up to $8,500,000.00. *See* TRIAL EXHIBIT 1. As noted, two members of the Debtor's Board of Governors are Wellmont Board members; a third is a former Wellmont Board member; the fourth and fifth Governors of the Debtor are Eddie George, President and CEO of Wellmont, and Ed Ollie, the Chief Financial Officer of Wellmont. Knowing the Wellmont Board of Directors had

agreed to pay up to $8,500,000.00, the Debtor's Governors fall considerably short of meeting their fiduciary duties to the unsecured creditors when they propose to sell the Debtor's operating assets to Wellmont for $4,000,000.00. Wellmont's argument that it did not want to lay all its cards on the table by exposing potential bidders to anything other than a minimum bid, only has merit if all prospective purchasers are playing on a level field. Here, they are not. The proposed sale is clearly tilted toward Wellmont becoming the purchaser of the Debtor's assets at a price most beneficial to Wellmont.

In summary, the Debtor has not established a good business purpose exists in selling the operating assets. The proposed sale does not "further the diverse interests of the Debtor, creditors, and equity holders, alike." *Stephens Industries*, 789 F.2d at 389. The only party assured to benefit from a § 363 sale at this time is Wellmont. If a sale is permitted, the unsecured creditors will have no certain interests in the Debtor's estate. The interest of the unsecured creditors will be best served by a plan of reorganization filed by a competitor or a Chapter 11 trustee, since Wellmont is unwilling to submit a plan of reorganization. This is not to say that the court will not entertain a proposed § 363 sale that is tailored to maximize the value of the Debtor's assets. Clearly, if the Chapter 11 trustee with the input of the Creditors Committee is able to put together a sale in the best interests of all parties, they will have an obligation to bring the same before the court.

The objections of the Committee and Carilion Consolidated Laboratories to the § 363 sale Motion will be sustained, and the Motion will be denied.

This Memorandum constitutes findings of fact and conclusions of law as required by Rule 52(a) of the Federal Rules of Civil Procedure. I will not ask the court reporter to transcribe my opinion. If she does so, it will be submitted to me for such corrections as I deem necessary, at which time the Memorandum will then be

filed and, of course, served on counsel for all parties in interest. An order memorializing this ruling will hopefully be entered this afternoon.

FILED: March 22, 2004

/s/ Richard Stair, Jr.
RICHARD STAIR, JR.
U.S. BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF TENNESSEE

In re

Case No. 03-31932

MEDEX REGIONAL LABORATORIES, LLC

Debtor

O R D E R

This contested matter came on for hearing on March 16, 2004, on the Motion for Appointment of a Trustee filed by the Unsecured Creditors Committee on January 5, 2004, on the Amended Motion to Sell Medex Regional Laboratories, LLC Operating Assets Free and Clear of Liens and Interests and for Approval of Bid Procedures With Assumption of Laboratory Services Agreement and Related Leases filed by the Debtor on March 9, 2004, on the Objection to Motion to Sell Assets and Request for Topping Fee filed by Carilion Consolidated Laboratories on February 20, 2004, and on the Objection of Unsecured Creditors Committee to Motion to Sell Medex Regional Laboratories, LLC Operating Assets Free and Clear of Liens and Interests and for Approval of Bid Procedures filed by the Unsecured Creditors Committee on February 20, 2004. For the reasons stated in the memorandum dictated from the bench on March 18, 2004, containing findings of fact and conclusions of law as required by Rule 52(a) of the Federal Rules of Civil Procedure, the court directs the following:

1. The Unsecured Creditors Committee's Motion for Appointment of a Trustee is GRANTED.

2. The United States Trustee, after consultation with parties in interest, shall appoint,

subject to the court's approval, one disinterested person other than the United States Trustee to serve as trustee in this Chapter 11 case.

3. The Objection to Motion to Sell Assets and Request for Topping Fee filed by Carilion Consolidated Laboratories and the Objection of Unsecured Creditors Committee to Motion to Sell Medex Regional Laboratories, LLC Operating Assets Free and Clear of Liens and Interests and for Approval of Bid Procedures filed by the Unsecured Creditors Committee are SUSTAINED.

4. The Amended Motion to Sell Medex Regional Laboratories, LLC Operating Assets Free and Clear of Liens and Interests and for Approval of Bid Procedures With Assumption of Laboratory Services Agreement and Related Leases filed by the Debtor on March 9, 2004, is DENIED.

SO ORDERED.

ENTER: March 18, 2004

BY THE COURT

/s/ Richard Stair, Jr.

RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE