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All Talk, but no Action Leads to the Loss of Ground Breaking Cancer Research

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Introduction

Each year, the government awards millions of dollars in federal grants to fund scientific research. Despite this huge allocation of resources, the government's claim in such funded research may be limited should the receiving institution become a debtor in bankruptcy. Last year, the United States Bankruptcy Court for the District of Massachusetts allowed the destruction of government funded research to benefit the debtor estate.¹

I. Selling Property under 11 U.S.C. § 363

Section 363 of the United States Bankruptcy Code (the "Bankruptcy Code") authorizes a trustee or debtor to sell, use, or lease property of the estate.² This section is applicable to chapter 7, 11, 12, and 13 cases. *Id.* Debtors are granted wide latitude in selling assets under section 363.³ Courts apply a business judgment rule test when evaluating a debtor's decision to sell, use, or

¹ *In re Genesys Research Inst., Inc*, 2016 Bankr. LEXIS 2376, at *87 (D. Mass. 2016).

² See 3 COLLIER ON BANKRUPTCY ¶ 363.01.

³ *In re Genesys*, 2016 Bankr. LEXIS 2376, at *65.

lease.⁴ Evidence that a debtor used reasonable business judgment includes “generation of revenue which will benefit the estate.”⁵ A debtor’s decision should be approved unless the decision demonstrates such unreasonableness that it seems to be made in bad faith or on a whim.⁶ Furthermore, an order approving a sale is subject to a bankruptcy judge’s discretion and should only be vacated when there is a clear showing of abuse of discretion.⁷

A. Sales Free and Clear of Liens and Interests: 11 U.S.C. 363(f)

Section 363(f) allows a debtor or trustee to sell property free and clear of interests under the following five scenarios: if (1) applicable bankruptcy law permits it; (2) such entity consents; (3) such interest is a lien and the price at which it will be sold is greater than the value of the lien; (4) such interest is in a bona fide dispute; and (5) such entity could be compelled to accept money satisfaction of the interest.⁸ The Trustee in *In re Genesys* relied on 11 U.S.C. § 363(f)(4) to sell the biological samples and research equipment expeditiously.⁹ When interpreting the provisions of 363(f) “[c]ase law has construed these standards expansively.”¹⁰ Property that may be sold “free and clear” includes “all legal and equitable interests of the debtor existing as of the commencement of the estate.”¹¹ “The purpose of the power to sell ‘free and clear’ is to avoid delay over disputes about validity of liens or interests.”¹²

⁴ *In re SW Boston Hotel Venture, LLC.*, No. 10-14535-JNF, 2010 Bankr. LEXIS 2924, at *3 (Bankr. D. Mass. 2010).

⁵ *Id.*

⁶ *Id.*

⁷ *Jeremiah v. Richardson*, 148 F.3d 17, 23 (1st Cir. 1998).

⁸ *See* 11 U.S.C. § 363(f).

⁹ *In re Genesys Research Inst., Inc.*, 2016 Bankr. LEXIS 2376, at *43 (D. Mass. 2016).

¹⁰ 3 COLLIER ON BANKRUPTCY ¶ 363.06.

¹¹ *In re Genesys*, 2016 Bankr. LEXIS 2376, at *64 (citing 11 U.S.C. § 541(a)(1)).

¹² *In re Genesys*, 2016 Bankr. LEXIS 2376, at *64; *see also In re Mundy Ranch, Inc.*, 484 B.R. 416, 422-23 (Bankr. D. N.M. 2012); *Moldo v. Clark (In re Clark)*, 266 B.R. 163, 171 (B.A.P. 9th Cir. 2001) (holding that “the liquidation of the estate’s assets should not be delayed.”).

The term “bona fide dispute” is not defined in 363(f)(4), however, courts have determined that a bona fide dispute exists when there is some objective basis for either a factual or legal dispute as to the validity of a debt.¹³ The court need not resolve the bona fide dispute, only whether one exists.¹⁴ The court in *In re Robotic Vision Sys., Inc.*, set out factors to determine whether a bona fide dispute exists.¹⁵ Courts should perform a case by case analysis taking into consideration: (1) the procedural posture of the case; (2) the need to expedite the sale; and (3) the nature of the basis for determining that a dispute exists. *Id.* The burden to prove such an interest rests on any “party asserting an interest in property being sold.”¹⁶ *In re Genesys* applied this analysis to an intellectual property interest asserted by the government.¹⁷

B. Application to a Governmental Interest

1. *In re Genesys*

In *In re Genesys* the Genesys Research Institute (the “Debtor”) was a “nonprofit corporation which conducted biological research and was partially funded by federal, state, and private grants.”¹⁸ In attempting to settle the estate, the Trustee filed a motion to dispose of biological materials and sell research equipment by public auction pursuant to section 363 (f) of the Bankruptcy Code.¹⁹ In support of his motion, the Trustee argued that no party had stepped forward to take custody and control of the materials and that the costs and burdens of maintaining the biological materials were considerable.²⁰ The Trustee concluded that the

¹³ *In re Genesys*, 2016 Bankr. LEXIS 2376, at *66 (citing *In re Octagon Roofing*, 123 B.R. 583 (Bankr. N.D. Ill. 1991)).

¹⁴ *In re Busick*, 831 F.2d 745, 750 (7th Cir. 1987).

¹⁵ 322 B.R. 502 (Bankr. D.N.H. 2005).

¹⁶ *In re Genesys*, 2016 Bankr. LEXIS 2376, at *69; *see also* 11 U.S.C. § 363(p)(2).

¹⁷ *In re Genesys*, 2016 Bankr. LEXIS 2376, at *62–69.

¹⁸ *Id.* at *2.

¹⁹ *Id.* at *34.

²⁰ *Id.* at *34–35.

disposition of the biological materials and the research equipment was warranted and necessary in furtherance of his duties as a Chapter 11 Trustee.²¹

Three parties filed objections to the Trustee's motion, the Department of Energy ("DOE"), Dr. Phillip Hahnfeldt, and Dr. Lynn Hlatky.²² The DOE and Dr. Hlatky made arguments asserting that the government interest prevented the Trustee from disposing of and selling the biological materials and equipment.²³ The DOE's "objection maintained that the United States had a right to control the Biological Materials and any research Equipment needed to continue DOE-funded research."²⁴ The DOE further argued that the United States' interest included the right to control the disposition of the biological materials and the sale of the equipment.²⁵ The basis of this argument was that the federal interest was outside of the Debtor's estate and therefore outside the Trustee's control.²⁶ In addition, the DOE cited 10 C.F.R. section 600.134(c) to argue that recipients of federal funds "shall use the equipment in the project or program for which it was acquired as long as needed, whether the project continues to be supported by Federal funds."²⁷ The DOE asserted that the Trustee could not dispose of any of the biological materials or sell the equipment so long as they are still needed for activities currently or previously supported by a Federal awarding agency.²⁸

Dr. Hlatky maintained that a substantial portion of the property identified in the Trustee's motion was not actually property of the Debtor's estate.²⁹ She asserted that the assets in question

²¹ *Id.*

²² *Id.* at *38–40.

²³ *Id.*

²⁴ *Id.* at *38.

²⁵ *Id.*

²⁶ *Id.* at *39 n.15.

²⁷ *Id.*

²⁸ *Id.* at *39–40 (citing 2 C.F.R. § 200.313(c) and 2 § C.F.R. 200.313(e)).

²⁹ *In re* Genesys, 2016 Bankr. LEXIS 2376., at *40.

were held in trust by the Debtor for the government institutions that funded the research.³⁰

“Hlatky also argued that the Debtor was merely a conduit through which federal grant money passed through to the researchers who obtained the grants.”³¹ She believed that the Debtor did nothing more than purchase the equipment so that the scientists would be able to perform the task set forth in the grant application.³²

The Court granted the motion to dispose of the biological materials and to sell the research equipment.³³ The Court rejected the arguments that the equipment and biological materials were not property of the estate.³⁴ The Court also noted that it was unnecessary to definitively resolve that issue because such an interest was in a bona fide dispute so the property could be sold free and clear of all interests.³⁵ Furthermore, the Court determined that effectuating the sale and disposition motion was in the best interest of the estate.³⁶

Hlatky filed a motion for reconsideration alleging that the Court erred when it concluded that the biological materials and research equipment were in a bona fide dispute.³⁷ She alleged that the equipment and biological materials were excluded from the definition of property under 11 U.S.C. § 541(a) and (d).³⁸ Furthermore, she alleged that they were not under a bona fide dispute because the Debtor received federal funds.³⁹ The Court denied her motion to reconsider

³⁰ *Id.* at *40–41.

³¹ *Id.* at *41.

³² *Id.*

³³ *Id.* at *42.

³⁴ *Id.*

³⁵ *Id.* at *43.

³⁶ *Id.* at *43.

³⁷ *Id.* at *50–51.

³⁸ *Id.* at *51.

³⁹ *Id.*

because “there were no manifest errors of fact or law.”⁴⁰ Thus, the Trustee was free to sell the property free and clear of all liens and interest because a bona fide dispute existed.⁴¹

2. Application of § 363(f) to the Tools and Fruits of Government Funded Research

One of the primary issues the Bankruptcy Court in *In re Genesys* had to address on reconsideration was whether it had erred in approving the sale and disposition of the biological materials and equipment free and clear of liens and interests. Unfortunately for the Government, the Department of Energy was unable to specifically identify any of the equipment or biological materials that were purchased with the use of federal funds.⁴² This factored into the practicality of potentially denying the motion to sell the equipment and destroy the biological materials. The biological materials and equipment were not catalogued or indexed so it would have been very difficult, if not impossible, to determine whether and to what extent the materials and equipment were bought with federal grants.⁴³ Furthermore, the Court noted that the DOE only asserted a property interest in the continuation of the research it had funded instead.⁴⁴

Additionally, the DOE did not rely on 11 U.S.C. § 363(d)(1) in any of its arguments.⁴⁵ Section 363(d)(1) states that a trustee may use, sell, or lease property in the case of a debtor that is not a moneyed business, in accordance with non-bankruptcy law.⁴⁶ The Debtor would have had to follow state laws governing nonprofit organizations and solicit offers from other

⁴⁰ *Id.* at *56.

⁴¹ *Id.* at *81–82.

⁴² *Id.* at *72.

⁴³ *Id.* at *74; *see also In re Madison County Economic Opportunity Com.*, 53 B.R. 541 (Bankr. S.D. Ill. 1985) (finding that the tight control retained over the grant funds created an equitable lien).

⁴⁴ *In re Genesys*, 2016 Bankr. LEXIS 2376., at *74.

⁴⁵ *Id.* at *72.

⁴⁶ *Id.* at *72 n.18; *see also* 11 U.S.C. § 363 (d)(1).

charitable organizations.⁴⁷ Because the DOE did not formulate any argument in reliance to this statute, the Court ruled that the DOE waived its reliance on this statute.⁴⁸ Therefore, the Court did not have to analyze whether the Trustee had to solicit offers from other charitable organizations before disposing of the biological materials and equipment.

In summarizing the bona fide dispute between the DOE and the Debtor, the Court noted that the Trustee asserted that the biological materials and the equipment were property of the estate even though they were bought with federal grants.⁴⁹ The DOE simply asserted a partial interest in some of the equipment and was unable to specifically identify that equipment.⁵⁰

The bona fide dispute concerning the interest in the alleged government property was also objected to by Dr. Hlatky because they were federally funded.⁵¹ However, the Court held that Dr. Hlatky did not have standing to assert the rights or interests of the United States.⁵² She did not cite to any legal authority which allowed her to act on behalf of the government.⁵³ Additionally, she could not assert an interest because she did not establish any “legal exposure” if the sale and disposition motion was carried out.⁵⁴ One case that Dr. Hlatky used to oppose the motion was *City of Springfield v. Ostrander (In re LAN Tamers, Inc.)*.⁵⁵ In that case the debtor,

⁴⁷ *In re Genesys*, 2016 Bankr. LEXIS 2376, at *14 (earlier in the case the Court ordered “that there should be specific solicitation to public charities and research laboratories for the Debtor to fulfill its obligations under non-bankruptcy law.”).

⁴⁸ *Id.* at *73.

⁴⁹ *Id.* at *69.

⁵⁰ *Id.* at *69–70, 72.

⁵¹ *Id.* at *70.

⁵² *Id.* at *71.

⁵³ *Id.*; see *In re Autosport Int’l, Inc.*, 2013 Bankr. LEXIS 2530, at *5 (Bankr. C.D. Cal. 2013) (to have standing in a bankruptcy case a party must show that a bankruptcy court’s order will diminish the party’s property, increase its burdens, or detrimentally affect its rights).

⁵⁴ *Id.*

⁵⁵ 329 F.3d 204 (1st Cir. 2003).

received federal money to maintain internet networks at various schools.⁵⁶ When the debtor went bankrupt the City of Springfield had already paid the debtor to fulfill a contract.⁵⁷ The issue was whether these federal monies, held by a government entity, were part of the debtor estate.⁵⁸ The court held that the debtor was a service provider for the City of Springfield and was simply a conduit or agent for the payment.⁵⁹ The court held that the funds belonged to Springfield and were not part of the estate. The funds were essentially being held in either a constructive trust or resulting trust for the benefit of the City of Springfield.⁶⁰ The Trustee distinguished this case because in *In re Genesys*, the funds were deposited directly into the Debtor's accounts without restriction as opposed to *In re LAN Tamers* where the funds were government money only being held in trust by the debtor.⁶¹

One case the Trustee relied on, and the Court agreed with, in support of its contention that a chapter 11 debtor is entitled to use grants to pay creditors is *Boston Reg'l Med. Ctr., Inc. v. Reynolds (In re Boston Reg'l Med. Ctr., Inc.)*.⁶² In that case a nonprofit hospital went bankrupt and attempted to use grant money to pay its creditors.⁶³ The debtor-hospital was granted money as part of a bequest in a testamentary trust.⁶⁴ The hospital sought an order turning over the funds to it so that it may pay off its creditors.⁶⁵ The opposition argued that because the hospital ceased to exist it could no longer perform its charitable purpose and it should not be entitled to that

⁵⁶ *Id.* at 206.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 210.

⁶⁰ *Id.* at 209.

⁶¹ Compare *In re Genesys*, 2016 Bankr. LEXIS 2376, at *76, with *In re LAN Tamers, Inc.* at 209.

⁶² 298 B.R., at *1 (Bankr. D. Mass. 2003), *aff'd*, 410 F.3d 100 (1st Cir. 2005).

⁶³ *Id.* at *3.

⁶⁴ *Id.*

⁶⁵ *Id.*

grant.⁶⁶ The court held that the running of a nonprofit requires the work of many individuals.⁶⁷ If these individuals are not paid contemporaneously with their services, they become creditors.⁶⁸ “Without payment of these creditors, a hospital, even a not-for-profit hospital, simply would not exist. The payment of creditors is essential and integral to the carrying out of the charitable mission of the hospital.”⁶⁹ Thus, the Court supports the proposition that even though the Debtor ceased operations for which the grant money was given, it is still entitled to use that grant money to satisfy its debts to creditors.⁷⁰

In summarizing its analysis, the court held that the Trustee established that the DOE’s interest was in a bona fide dispute.⁷¹ “The Court determined that the Trustee exercised sound business judgment and that the sale was in the best interests of the creditors of the bankruptcy estate.”⁷²

II. Conclusion

When a non-profit debtor receives federal grant money, it may nevertheless sell that property to advance the best interests of the estate and its creditors, whether it would be saving money or making money to settle accounts. If there is a dispute regarding a government interest in property with respect to federal funds the government previously provided, 363(f)(4) of the Bankruptcy Code allows the sale of such property free and clear of any interest. The trustee may handle the government funded property however he or she deems is best and the court will not have to resolve the dispute. Weighing into the consideration whether a bona fide dispute exists,

⁶⁶ *Id.*

⁶⁷ *Id.* at *28.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *In re* Genesys Research Inst., Inc, 2016 Bankr. LEXIS 2376, at *76 (D. Mass. 2016).

⁷¹ *Id.* * 81.

⁷² *Id.* at *81–82.

will be the ease with which the property purchased with government funds can be identified. If the court would have great difficulty identifying the assets that the federal grants specifically funded, it is more likely that the court would find there is a bona fide dispute and grant the sale of the property. Thus, when grant money is deposited directly into accounts without any restriction, such funding will give rise to such difficulty in identifying what the grant money specifically funded. As for third parties who want to assert a government interest, they must have standing to do so. If they do not personally have any legal exposure, they will have to cite to some authority which enables them to act on behalf of the United States or any other governmental entity.