IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
GRACEWAY PHARMACEUTICALS, LLC, *et al*.,[1]	Case No. 11-13036 (PJW)
	Jointly Administered
Debtors.	**Response Deadline: February 29, 2012 at 4:00 p.m. (ET)** **Hearing Date: March 16, 2012 at 9:30 a.m. (ET)**

DEBTORS' OBJECTION TO PROOF OF CLAIM NO. 192
FILED BY CVS CAREMARK CORPORATION

The above-captioned debtors and debtors-in-possession (collectively, the "**Debtors**") hereby file this objection (the "**Objection**") to proof of claim no. 192 (the "**CVS Claim**") filed against the Debtors by CVS Caremark Corporation[2] ("**CVS**"), pursuant to Section 502(b) of title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (the "**Bankruptcy Code**"), Rules 3001, 3003 and 3007 of the Federal Rules of Bankruptcy Procedure (the "**Bankruptcy Rules**"), and Rule 3007-1 of the Local Rules of Bankruptcy Practice and Procedure of the United States Bankruptcy Court for the District of Delaware (the "**Local Rules**"), and respectfully request entry of an order in substantially the same form as the proposed

[1] The Debtors in these cases, along with the last four digits of each Debtor's federal tax identification number, are: Graceway Pharma Holding Corp., a Delaware corporation (9175), Case No. 11-13037 (PJW); Graceway Holdings, LLC, a Delaware limited liability company (2502), Case No. 11-13038 (PJW); Graceway Pharmaceuticals, LLC, a Delaware limited liability company (5385), Case No. 11-13036 (PJW); Chester Valley Holdings, LLC, a Delaware limited liability company (9457), Case No. 11-13039 (PJW); Chester Valley Pharmaceuticals, LLC, a Delaware limited liability company (3713), Case No. 11-13041 (PJW); Graceway Canada Holdings, Inc., a Delaware corporation (6663), Case No. 11-13042 (PJW); and Graceway International, Inc., a Delaware corporation (2399), Case No. 11-13043 (PJW). The mailing address for Graceway Pharmaceuticals, LLC is 340 Martin Luther King Jr. Blvd., Suite 400, Bristol, TN 37620 (Attn: John Bellamy). On October 4, 2011, Graceway Canada Company filed an application in the Ontario Superior Court of Justice (Commercial List) pursuant to the *Courts of Justice Act*, R.S.O. 1990, c. C. 43.

[2] The CVS Caremark Corporation filed proofs of claim in these cases against Graceway Pharmaceuticals, LLC, by the following creditor entities: CVS Caremark Part D Service, L.L.C. (Claim No. 189), CaremarkPCS Health L.L.C. (Claim No. 190), Caremark, L.L.C. (Claim No. 191), and CVS Caremark Corporation (Claim No. 192). The Debtors only wish to respond to Claim No. 192 in this Objection and reserve further rights to allow or object to CVS' other claims.

form of order (the "**Proposed Order**") attached hereto as Exhibit II. In support of this Objection, the Debtors respectfully represent as follows[3]:

JURISDICTION

1. This Court has jurisdiction over this Objection pursuant to 28 U.S.C. §§ 157 and 1334. Venue is proper in this District pursuant to 28 U.S.C. §§ 1408 and 1409. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2).

2. The statutory and legal predicates for the relief sought herein are Section 502(b) of the Bankruptcy Code, Bankruptcy Rules 3001, 3003 and 3007, and Local Rule 3007-1.

INTRODUCTION

3. The CVS Claim seeks approximately $22.7 million on account of purported contingent liabilities for future product returns. Such liabilities are grossly exaggerated. The CVS Claim represents a bold and misleading attempt to extract payments from the Debtors' estates without any basis under CVS's contracts with the Debtors, CVS's course of dealing with the Debtors and their wholesalers or the Bankruptcy Code. Any payments to CVS would necessarily be made at the direct expense of the other creditors of the Debtors' estates. Thus, law, equity and the unambiguous terms of the agreements that CVS relies upon compels denial of the CVS Claim.

BACKGROUND: THE CHAPTER 11 CASES

4. On September 29, 2011, each of the Debtors filed a petition with this Court under chapter 11 of the Bankruptcy Code (collectively, the "**Chapter 11 Cases**"). The Debtors are operating their businesses and managing their properties as debtors-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code. On September 30, 2011, the

[3] The facts and circumstances supporting this Objection are set forth in the Declaration of Thomas E. Hill in Support of Debtors' Objection To Claim No. 192 Pursuant to § 502(b) of the Bankruptcy Code, Bankruptcy Rules 3001, 3003 and 3007, and Local Rule 3007-1.

Court entered an order consolidating these Chapter 11 Cases for procedural purposes only [Docket No. 42].

5. These Chapter 11 Cases are pending before the Honorable Peter J. Walsh, Judge for the United States Bankruptcy Court for the District of Delaware, located at the United States Bankruptcy Court, 824 North Market Street, 6th Floor, Wilmington, Delaware 19801 (the "**Bankruptcy Court**"). On October 11, 2011, the Office of the United States Trustee appointed an official committee of unsecured creditors pursuant to Section 1102 of the Bankruptcy Code (the "**Creditors' Committee**") [Docket No. 90].

6. On October 17, 2011, this Court entered the *Order Establishing Bar Dates For Filing Proofs of Claim and Approving The Form And Manner of Notice Thereof* [Docket No. 126] (the "**Bar Date Order**"), which established that any person or entity (excluding any governmental unit, as defined in Section 101(27) of the Bankruptcy Code), asserting a claim against the Debtors in these Chapter 11 Cases must file a proof of claim (a "**Proof of Claim**") so that it is received by the Voting and Claims Agent on or before 4:00 p.m. (prevailing Eastern Time) on the date that is sixty (60) days after the Debtors' filed their schedules of assets and liabilities and statements of financial affairs (the "**Schedules and Statements**").

7. The Debtors filed their Schedules and Statements on October 31, 2011. Accordingly, December 30, 2011 at 4:00 p.m. (prevailing Eastern Time) was the deadline for filing proofs of claims against the Debtors (the "**Bar Date**"), other than claims of governmental units and administrative expense claims. Further, the Bar Date Order established that all governmental units asserting claims against one or more of the Debtors must file proofs of claim so that they are received by the Voting and Claims Agent on or before March 27, 2012 at 4:00 p.m. (prevailing Eastern Time).

8. Notice of the Bar Date was mailed to all known creditors on November 1, 2011. *See* Affidavit of Service filed by the Voting and Claims Agent on November 8, 2011 [Docket No. 230]. In addition, on November 7, 2011, the Debtors published notice of the Bar Date in the Wall Street Journal (national edition).

9. The Debtors and their professionals have been reviewing, analyzing and resolving claims on an ongoing basis as part of the claims reconciliation process.

10. On December 2, 2011, the Debtors filed a motion to, among other things, reject certain executory contracts, effective as of December 31, 2011 (the "**Rejection Motion**") [Docket No. 333]. The Debtors designated all agreements it held with CVS and with Cardinal (as defined and further explained below) to be rejected under the Rejection Motion. On December 28, 2011, this Court entered the Order granting the Rejection Motion [Docket No. 416].

THE CLAIMANT: CVS CORPORATION

11. CVS and its affiliated entities have been selling the Debtors' prescription drug products throughout their retail network since the Debtors commenced operations in 2007. CVS purchases the Debtors' products primarily from Cardinal Health 411, Inc. and its affiliates ("**Cardinal**"), but also from certain other pharmaceutical distributors. Cardinal is a "wholesaler" that purchases products from the Debtors, and various other pharmaceutical producers, and then resells such products to retailers like CVS. Wholesalers like Cardinal form an integral part of the Debtors' distribution system because the Debtors do not have the infrastructure to distribute and supply their products to the vast array of retailers, pharmacies and health care facilities that dispense their product. In the ordinary course, the Debtors sell and ship their products to Cardinal and other wholesalers who, in turn, sell and distribute the products to retailers such as

CVS. Cardinal is paid by CVS and other retailers on account of the product Cardinal re-sells. Whether Cardinal is able to re-sell product does not impact Cardinal's obligations to the Debtors, and the Debtors generally do not directly supply product to retailers such as CVS.[4]

12. As part of Cardinal's relationship with various retailers, Cardinal incurs certain liabilities to retailers on account of the return of defective or expired product from CVS and other retailers.

13. The vast majority of the Debtors' products have a shelf-life between 2 to 4 years and all are date-stamped with an expected expiration date. The Debtors' product return policy period generally begins 6 months in advance of a product's expiration date and extends several months beyond the expiration date.

14. When a retailer such as CVS wishes to return defective or expired product it ships the product back to Cardinal or one of the other wholesalers via a third party returns processor. Cardinal credits CVS' account with Cardinal for the value of such products returned. Cardinal then aggregates CVS' credits with credits from other retailers and submits an aggregate claim to the Debtors for verification. The Debtors receive returned goods from the third party returns processor in order to conduct an inspection to determine whether such returns were valid under the Debtors' return policy with the wholesalers. If the Debtors determine that such returns were valid, a credit is issued to the wholesaler with a notation regarding the retailer that returned the product to the wholesaler (via the third party processor) to whom the credit relates.

15. In addition, the Debtors have executed certain third-party agreements with CVS to enable CVS to receive a preferred pricing schedule from Cardinal and to participate in certain Medicaid / Medicare rebate programs. The Debtors also agreed to extend to CVS certain

[4] On occasion, and pursuant to separate agreements, the Debtors will sell a small volume of their product Minitran to CVS for direct online sales.

allowances from the Debtors' standard product returns policy, pursuant to that certain product returns policy letter dated June 25, 2009 (the "**CVS Product Returns Policy Letter**") and the accompanying CVS Caremark Return Goods Policy and Product Recall / Withdrawal Policy (the "**CVS Product Returns Policy**" and, collectively with the Product Returns Policy Letter, the "**CVS Product Returns Agreement**").

16. The CVS returns policy is in many ways consistent with the Debtors' typical return practice. The CVS Product Returns Policy Letter provides, in pertinent part:

> Return Window – 6 months prior, up to 12 months post expiration
>
> Valuation - *credit* will be issued at the current manufacturer's list price (WAC [the Wholesalers Acquisition Cost]) at the time of return, less 10%
>
> Partials – partial quantities will be accepted irrespective of amount and credited to the tablet/unit level

Product Returns Policy Letter, page 1 (emphasis added)

17. The CVS Product Returns Policy also provides, in pertinent part: "*[c]redit* will be issued for all returned product whether purchased directly from the manufacturer / supplier or indirectly from a wholesaler." CVS Product Returns Policy, page 1 (emphasis added).

18. In accordance with the CVS Product Returns Policy Letter and the CVS Product Returns Policy, the Debtors issue a "credit-memo" to the wholesaler for any returns received from the third party processor that reference the retailer who returned product reviewed and authenticated by the Debtors. The Debtors do not make cash payments to retailers on account of product returns and there is no agreement with CVS or any other retailer that requires the Debtors to do so.

THE CVS CLAIM

19. On December 30, 2011, CVS Caremark Corporation filed the CVS Claim against the Debtors on behalf of its affiliated entities. The CVS Claim alleges a total amount owed of $22,658,639.01, comprised of $1,578,365.01 for current product returns and $21,080,274 for contingent future product returns. CVS derived this claim amount by calculating an average quarterly return rate for 2011 of $1.5 million and then extrapolating this figure by three and one-half years to obtain a total of approximately $21.0 million. CVS describes this figure as the total expected future return claim. CVS also asserts in its claim that it holds approximately $1,578,365.01 in recoupment and/or setoff rights against Graceway on account of amounts that it owes to Graceway for product purchases.

20. The only support that CVS provides for its claim is identified in footnote 2 to the Rider attached to the CVS Claim:

> Invoices and other supporting documents summarizing the amounts currently owed are not attached to the proof of claim because they are voluminous. Copies of the invoices, however, have been previously sent to Graceway and are available upon request by Graceway.

Footnote 2, Rider to the CVS Claim

21. After analyzing their books and records, the relevant provisions of the Bankruptcy Code, and the applicable caselaw, the Debtors dispute the CVS claim and believe in good faith that they hold no contractual liability or obligation that supports the CVS Claim. The Debtors also believe that all setoff or recoupment rights asserted by CVS are invalid.

REQUESTED RELIEF

22. The Debtors hereby object to the CVS Claim and seek entry of an order, pursuant to § 502(b) of the Bankruptcy Code and Bankruptcy Rules 3001, 3003 and 3007, disallowing Claim No. 192 in its entirety.

OBJECTION TO THE CLAIM

I. The CVS Claim Is Derived from Inaccurate Assumptions and Is Wildly Exaggerated

23. The CVS Claim is grossly overstated because CVS utilizes incorrect assumptions in their calculation of historical product return rates. CVS includes in its assessment of historical return rates the returns for the Debtors' product Aldara® (imiquimod) Cream 5% ("**Aldara**"). The inclusion of this product dramatically overstates the Debtors' historical rate of product returns because Aldara suffered extraordinarily high returns after the entrance of generic competitors in 2010.[5] However, now that the Aldara returns have worked their way through the system, future return rates are expected to return to their historical averages, which are a fraction of the amount that CVS projects.

24. CVS reported in its claim that total product returns for 2011, including Aldara, had reached $10.1 million. The Debtors do not dispute this estimate. However, the Debtors note that this figure includes Aldara returns, which were $8.8 million in 2011. All other product returns totaled $1.3 million in 2011. The Debtors note that the extraordinary spike in Aldara returns in 2011 has now subsided because the vast majority of Aldara inventory has expired and already been returned. In Q4 of 2011, for instance, the average returns of Aldara from CVS had dropped to only $37,000 per month.

[5] Aldara had historically been the Debtors' best-selling product and accounted for 80% of the Debtors' total net sales in 2009. However, sales of Aldara fell to 24% of the Debtors' net sales in 2010 and were down to 16% of net sales by the first part of 2011. The reason for the dramatic decline was due to the loss of patent exclusivity in February, 2010, and the sudden onslaught of generic competition. Wholesalers immediately stopped purchasing Aldara and switched to the generic brands. A large inventory of product could not be sold due to the lower priced alternatives. *See Declaration of Gregory C. Jones in Support of Chapter 11 Petitions and First Day Motions*, filed September 29, 2011 in these Chapter 11 Cases [Docket No. 3]. As this unsold inventory began to age and approach their rolling expiration dates, wholesalers were permitted under the return policies to return such product to the Debtors for credit. The final batch of products that had been sold just before the entry of the generic brands finally became eligible for return in Q2 of 2011 and the Debtors' product return rates swelled at this time. *See Declaration of Thomas E. Hill In Support of Debtors' Objection to Claim No. 192 Pursuant to § 502(b) of the Bankruptcy Code,* attached hereto as Exhibit I.

25. CVS then asserts that going forward, the quarterly rate of product returns is expected to be $1.5 million, or approximately $6.0 million per year. Such assumptions dramatically exaggerate historical return rates. For instance, historical product returns—excluding Aldara—totaled only $1.0 million in 2008, $1.1 million in 2009, $0.9 million in 2010, and $1.3 million in 2011. The CVS Claim amount of $22.7 million is thus more than five times larger than any historical comparisons would support.

26. Since there is virtually no remaining Aldara inventory in the marketplace, and since none of the Debtors' other products sold during the prepetition or postpetition periods are expected to face the same competition from generic competitors as that faced by Aldara, using Aldara return rates to forecast future returns of the Debtors' products is inappropriate and misleading. Therefore, based on the evidence presented, the Debtors do not believe that the CVS Claim is derived from any reasonable interpretation of historical product return rates and find the CVS Claim amount to be wildly overstated.

II. CVS Holds No Contractual Privity with the Debtors and Any Remedies for Product Return Claims are Payable to Cardinal, Not CVS

27. It is a well established principle of contract law that privity must exist between two parties to a contract. *See Austin v. Seligman*, 18 F. 519, 521 (C.C.D.N.Y. 1883) (privity of contract is required for liability to be found); see also *Prudential Ins. Co. v. Dewey Ballantine, Bushby, Palmer & Wood*, 605 N.E.2d 318, 322 (N.Y. 1992) ("[t]he rationale for the requirement of privity is that it is necessary in order to provide fair and manageable bounds to what otherwise could prove to be limitless liability"). Upon a return of expired product to the Debtors, pursuant to the CVS Product Return Agreement, the Debtors are obligated to issue credit memos *to Cardinal* for the value of such products. Whether Cardinal chooses to pass

along those credit memos to CVS is a matter and decision that is entirely out of the Debtors' control and subject to the terms of Cardinal's contractual relationship with CVS.

28. Since the contractual remedy for receipt of valid product returns is limited solely to the issuance of credit memos *to Cardinal*, and because the Debtors have no additional obligation to make any credit or cash payment directly to CVS, the Debtors hold no obligation to, or privity with, CVS. *See, for e.g., In re Spiegel, Inc.,* 2005 Bankr. LEXIS 290 (Bankr. S.D.N.Y. Feb. 18, 2005) (unpublished) (court determined that there was no privity of contract between a third party and the debtor under a swap agreement and so debtors could not be obligated for termination damages to such third party). Since CVS holds no privity with the Debtors, they do not hold the right to bring this claim and it should be disallowed.

III. The CVS Claim Lacks Supporting Evidence and Contradicts The Information In the Debtors' Possession

a. CVS has not identified any contractual basis for its claim

29. Contracts must be interpreted in accordance with their express terms. 17 Am. Jur. 2d *Contracts* § 337; *see also Matria Healthcare, Inc. v. Coral SR LLC*, 2007 Del. Ch. LEXIS 32 at *20 (Del. Ch. Mar. 1, 2007) ("[w]hen interpreting a contract, the Court's function is to… initially look[] to the contract's express terms…"); *see also, Energy Partners, Ltd. v. Stone Energy Corp.*, 2006 Del. Ch. LEXIS 182 at *13 (Del. Ch. Oct. 11, 2006) ("a finding that a contract's disputed language is unambiguous compels the Court to rely solely on the clear, literal meaning of the words of the contract").

30. Here, CVS has offered no contractual basis to support its claim. The only contractual provision that CVS offers to underpin its claim is the statement, "[p]ursuant to agreements between and/or among CVS Caremark, Graceway and Cardinal Health411, Inc. and its affiliates," CVS "possesses, among other things, a right to return such products to Graceway."

CVS does not specifically identify which agreements or provisions purportedly provide such right.

31. The Debtors have reviewed their books and records and believe that, to the best of their knowledge, the only right of return that CVS holds is pursuant to that certain CVS Product Returns Agreement. The CVS Product Returns Agreement reaffirms the Debtors' standard practice of issuing *credit* against future purchases by Cardinal for all validly returned product. Nothing under the CVS Product Returns Policy Letter obligates the Debtors to make a cash payment to CVS (or to Cardinal for that matter). Here, since all product sales concluded on the day of the closing of the sale of the Debtors' business to the Buyers, there can be no future sales by the Debtors to Cardinal (or any other wholesaler) and nothing for the Debtors to credit against. Thus, CVS has not met its burden to establish any contractual obligations or explain why it is entitled to cash payment on account of unliquidated, contingent product returns.

b. CVS has not provided any supporting documentation to substantiate its claim

32. CVS asserts that the CVS Claim is based on "estimated," contingent amounts owed for product returns that might occur over the next "three and one-half years," and up until "the second quarter of 2015." Claim No. 192, at 2. CVS then derives a highly speculative and wildly exaggerated estimate, without sufficient elaboration, that the value of future contingent return liabilities is $21,080,274. *Id.*

33. CVS has not provided any invoices, documentation or other evidence to support its calculations, in violation of Rule 3001. To the contrary, documentation in the Debtors' possession contradicts all of the assumptions asserted by CVS. According to a review of their books and records, the Debtors believe in good faith that CVS is not owed any amounts by the Debtors for alleged returns.

34. CVS cannot be permitted to assert that its claims are "estimates," provide no substantiation or contractual basis for the assumptions or calculations it uses, and then simultaneously assign to them a dollar value.

IV. The Setoff that CVS Asserts is Not Permissible Because It Is Not "Mutual" and Was Not Asserted Prepetition

35. As explained above, CVS does not hold a valid claim on account of product returns. However, even if CVS were deemed to hold valid unliquidated or contingent product return claims against the Debtors, it would not be permissible for CVS to assert setoff or recoupment rights against such claims.

a. CVS' purported setoff is invalid because CVS holds no mutuality with the Debtors

36. Section 553(a) of the Bankruptcy Code provides that a creditor may "offset a *mutual* debt owing by such creditor to the debtor that arose before the commencement of the [bankruptcy] case… against a claim of such creditor against the debtor…" 11 U.S.C. § 553(a). "[S]etoff is appropriate in bankruptcy only when a creditor both enjoys an independent right of setoff under applicable non-bankruptcy law, and meets the further Code-imposed requirements and limitations set forth in section 553." *In re Semcrude, L.P.*, 399 B.R. 388, 393 (Bankr. D. Del. 2009)[6]; *see also* "even where a setoff right exists under applicable state law, the Bankruptcy Code imposes its own strict requirements..." *In re Lehman Bros., Inc.*, 458 B.R. 134, 140 (Bankr. S.D.N.Y. 2011). The party seeking setoff "has the burden to prove

[6] There are four elements that are generally necessary to establish a creditor's right to a setoff: (1) a debt owing by the creditor to the debtor which arose before the commencement of the case; (2) a claim of the creditor against the debtor which also arose before commencement of the case; (3) mutuality of the debt and claim; and (4) the claim and debt are each valid and enforceable. *See 3-553 Collier Bankruptcy Manual, 3d Edition Revised P 553.01; see also In re High Sierra Transport, Inc.*, 101 B.R. 432, 436 (Bankr. M.D. Pa. 1989); *see also In re Public Serv. Co.*, 884 F.2d 11, 14 (1st Cir. N.H. 1989).

mutuality." *Id.* Additionally, "[i]t is . . . widely accepted that mutuality is strictly construed against the party seeking setoff." 399 B.R. at 396.

37. The meaning of "mutual debts" contained in § 553 has been interpreted by courts to mean that "debts must be in the same right and between the same parties, standing in the same capacity." *In re Drexel Burnham Lambert Group, Inc.*, 113 B.R. 830, 847 (Bankr. S.D.N.Y. 1990). If debts are not mutual, a creditor may not setoff his claim against the debtor against his own liability because the parties are acting in different capacities. "The long established right to set off mutual pre-petition debts owed to and owed by a creditor in the same capacity has its roots in the recognition that setoff is but another form of secured financing to be recognized in bankruptcy." *Id.* at 839.

38. Mutuality, as defined by courts, cannot exist in a "triangular" relationship when two parties do not hold contractual rights and obligations directly to each other but through intermediaries. "In order to effect a setoff in bankruptcy, courts construing the Code have long held that the debts to be offset must be mutual . . .." 399 B.R. at 396. "The authorities are . . . clear that debts are considered 'mutual' only when they are due to and from the same persons in the same capacity." *Id.* "Because of the mutuality requirement in section 553(a), courts have routinely held that triangular setoffs are impermissible in bankruptcy." *Id.* "Allowing a creditor to offset a debt it owes to one corporation against funds owed to it by another corporation -- even a wholly-owned subsidiary -- would thus constitute an improper triangular setoff under the Code." *Id.* Regardless of the triangular setoff rights that a contract between a debtor, creditor and third party may grant, "[t]here simply is no contract exception to section 553(a), because the statute itself does not allow for one." 458 B.R. at 142.

39. Here, CVS holds no mutuality with the Debtors with respect to the Debtors' products. Its relationship is held entirely with Cardinal, who distributes the Debtors' products to CVS and is entitled to payment by CVS for such products. Likewise, Graceway's obligation to provide a credit for product returns runs to Cardinal, not CVS. CVS presumably receives its credits or payments on account of product returns from Cardinal. There is no "mutuality" of debts between Graceway and CVS. In fact, there is no direct relationship with respect to the Debtors' products at all.

b. CVS cannot assert any setoff rights because setoff rights were not exercised prepetition

40. The Debtors have rejected any contracts held with CVS or Cardinal. Thus, any claim asserted by CVS arising from unliquidated, contingent product returns for products sold prepetition should rightfully be considered "rejection damages" and calculated as of the petition date.

41. Section 502(g) of the Bankruptcy Code provides:

> any claim arising from rejection of a previously unassumed contract… must be determined… as if the claim had arisen before the date of the filing of the petition… Contract rejection damages… are measured as of the petition date, not as of the rejection date.

11 U.S.C. § 502(g); *see also* 2-365 Collier Bankruptcy Manual, 3d Edition Revised P 365.10; see also *In re American HomePatient, Inc.*, 414 F.3d 614 (6th Cir. 2005) (damages for rejection of stock warrants based on stock price immediately before the petition date); *Taunton Mun. Lighting Plant v. Enron Corp. (In re Enron)*, 354 B.R. 652 (S.D.N.Y. 2006) (damages for rejection of electricity purchase contract based on electricity price immediately before the petition date).

42. The Third Circuit has permitted that rejection damages, as prepetition obligations, may be setoff against prepetition obligations owed by the debtor, provided that the

claim of setoff was exercised prepetition. *Folger Adam Sec., Inc. v. DeMatteis/MacGregor, J.V.*, 209 F.3d 252, 262 (3d Cir. Pa. 2000) ("it is not enough that the claim be a pre-petition claim, rather the pre-petition claim of setoff must have actually been exercised pre-petition"); *see also, In re Communication Dynamics, Inc.*, 382 B.R. 219, 232 (Bankr. D. Del. 2008). In other words, the right to setoff rejection damages cannot be asserted if those rights were not exercised prepetition. *See In re FormTech Indus., LLC*, 439 B.R. 352, 361-362 (Bankr. D. Del. 2010).

43. Even if the claim that CVS asserts is allowed as an unliquidated, contingent product return claim, CVS may not setoff amounts owed to the Debtors against such claim because no steps were taken prepetition by CVS to assert or exercise such setoff rights. Thus, any setoff claimed by CVS should be disallowed because of the lack of mutuality pursuant to Section 553(a) and the failure of CVS to assert such setoff rights prepetition.

c. CVS' purported recoupment rights are invalid because the alleged CVS claims do not arise out of the same transaction

44. The doctrine of recoupment is not incorporated under the Bankruptcy Code but was established by common law to permit "the setting off against asserted liabilities of a counterclaim arising out of the same transaction" *Reiter v. Cooper*, 507 U.S. 258, 264 (1993). Recoupment is applied strictly for "the purpose of abatement or reduction of such claim." *In re University Medical Center*, 973 F.2d 1065, 1079 (3d Cir. Pa. 1992). Unlike setoff, which allows for reductions arising from different contracts, or recoupment to apply, "both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." *University Medical Center*, 973 F.2d at 1081; *see also In re FormTech Indus., LLC*, 439 B.R. 352, 362 (Bankr. D. Del. 2010).

45. As explained above, there is no privity or mutuality between the parties and therefore no single contract or transaction that would permit an offset against asserted liabilities. While CVS may participate in a triangular relationship with the Debtors via Cardinal, there are no direct transactions with CVS that would generate mutual obligations that could facilitate recoupment. The "fact that the same two parties are involved, and that a similar subject matter gave rise to both claims, [] does not mean that the two arose from the 'same transaction.'" *University Medical Center*, 973 F.2d at 1081. Therefore, CVS may not validly rely on the doctrine of recoupment to offset any product return claims.

RESERVATION OF RIGHTS

46. The Debtors expressly reserve the right to amend, modify or supplement this Objection and to file additional objections to any CVS proofs of claims filed in these Chapter 11 Cases including, without limitation, objections as to the liability, amount or priority of any claim filed by CVS. Should one or more of the grounds for this Objection be dismissed or overruled, the Debtors reserve the right to object to any portion of the CVS Claim on any other ground.

STATEMENT OF COMPLIANCE WITH LOCAL BANKRUPTCY RULE 3007-1

47. The undersigned representative of Young Conaway Stargatt & Taylor, LLP has reviewed the requirements of Local Rule 3007-1 and certifies that the Objection substantially complies with that Local Rule. To the extent that the Objection does not comply in all respects with the requirements of Local Rule 3007-1, the Debtors believe such deviations are not material and respectfully request that any such requirement be waived.

FURTHER INFORMATION

48. Questions about or requests for additional information about this Objection should be directed to the Debtors' counsel in writing at the following address: Latham

& Watkins LLP, 233 South Wacker Drive, Suite 5800, Chicago, Illinois 60606 (Attn: Matthew L. Warren, Esq.) or by telephone at (312) 777-7031 or by e-mail at matthew.warren@lw.com.

49. Claimants should not contact the Clerk of the Court to discuss the merits of their proofs of claim or this Objection.

NOTICE

50. The Debtors have provided notice of this Objection to: (a) the United States Trustee for the District of Delaware; (b) financing counsel to the administrative agent for the lenders under the Debtors' first lien facility; (c) special restructuring and bankruptcy counsel to the administrative agent for the lenders under the Debtors' first lien facility; (d) counsel to the administrative agent for the lenders under the Debtors' second lien facility; (e) the administrative agent for the lenders under the Debtors' prepetition unsecured mezzanine credit facility; (f) counsel to the Creditors' Committee; (g) the creditors listed on the Debtors' consolidated list of 30 largest unsecured creditors, as filed with the Debtors' chapter 11 petitions; (h) the Food and Drug Administration; (i) the Internal Revenue Service; (j) the U.S. Public Health Service; (k) the Centers for Medicare and Medicaid Services; (l) counsel to, receiver for, and counsel to the receiver for Graceway Canada Company (m) the claimant CVS; and (n) all parties requesting notice pursuant to Bankruptcy Rule 2002. In light of the nature of the relief requested, the Debtors submit that no further notice is required or needed under the circumstances.

51. A copy of this Objection is available on the Court's website: www.deb.uscourts.gov. Additional copies are available for free on the website of the Voting and Claims Agent at www.bmcgroup.com/graceway, or can be requested by calling (888) 909-0100 from within the United States or +1 (310) 321-5555 if calling from outside the United States.

CONCLUSION

WHEREFORE, the Debtors respectfully request that the Court enter an order substantially in the form attached hereto as Exhibit II: (i) granting the relief requested herein; and (ii) granting to the Debtors such other and further relief as the Court may deem just and proper.

Dated: February 15, 2012
Wilmington, Delaware

Respectfully Submitted,

/s/ Kara Hammond Coyle

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