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.	**Objection Deadline: May 2, 2012 at 4:00 p.m.** **Hearing Date: May 9, 2012 at 10:30 a.m.**

MOTION OF CARDINAL HEALTH FOR (I) RELIEF FROM THE AUTOMATIC STAY PURSUANT TO 11 U.S.C. § 362(d) AND (II) APPROVAL OF SETOFF UNDER 11 U.S.C. § 553

Cardinal Health ("Cardinal")[2], by and through its undersigned counsel, hereby files this motion (the "Motion") pursuant to sections 105(a), 362(d)(1) and 553(a) of title 11 of the United States Code for an order (the "Order"), substantially in the form attached hereto as **Exhibit A**, granting relief from the automatic stay to the extent necessary to setoff mutual debts between the above captioned debtors (the "Debtors") and Cardinal. In support of the Motion, Cardinal respectfully states as follows:

[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] As used herein, the term "Cardinal Health" means the following affiliated operating companies and subsidiaries of Cardinal Health, Inc., an Ohio corporation ("CHI"): Cardinal Health 3, LLC; Cardinal Health 104 LP; Cardinal Health 107, Inc.; Cardinal Health 107, LLC.; Cardinal Health 108, Inc.; Cardinal Health 110, Inc.; Cardinal Health 112, LLC; Cardinal Health 113, LLC; Cardinal Health 411, Inc.; Borschow Hospital & Medical Supplies, Inc. Under the Agreements (defined herein), CHI may designate any other subsidiary as "Cardinal Health".

PRELIMINARY STATEMENT

1. In the ordinary course of its business, Cardinal entered into a Wholesale Purchase Agreement ("WPA") and a Distribution Service Agreement ("DSA") (collectively, the "Agreements") with one of the Debtors, Graceway Pharmaceuticals, LLC ("Graceway"), pursuant to which it (1) purchased pharmaceutical products from Graceway for subsequent resale to various entities, including, but not limited to, hospitals, supermarkets, pharmacies, nursing homes, and clinics; and (2) provided distribution services to Graceway for its pharmaceutical products in exchange for a fee. Prior to the Debtors' bankruptcy filings, Cardinal purchased pharmaceutical products from Graceway for which some payments remain outstanding (the "Graceway Prepetition Claim"). Similarly, Graceway issued to Cardinal prepetition credits memos which remain unapplied. On December 22, 2011, Cardinal filed a proof of claim ("Claim No. 144") with respect to its prepetition claims. Included in **Exhibit B** attached hereto is Claim No. 144 filed by Cardinal in the above-captioned bankruptcy proceeding, which reflects these mutual obligations.

2. Cardinal seeks to exercise its right to setoff the Cardinal Prepetition Claim against the Graceway Prepetition Claim. Setoff is a right Cardinal has under Ohio law, the governing law pursuant to choice of law provisions in each of the Agreements. These reciprocal obligations are valid and enforceable obligations which arose prepetition in the parties' ordinary course of business dealings. Each party is indebted to the other on account of such obligations in its own name and not as a fiduciary. Accordingly, Cardinal has a right of setoff which is preserved under section 553(a) of the Bankruptcy Code.

3. After the Debtors sought bankruptcy protections, the parties continued their business relationship in the ordinary course. Each party is indebted to the other on account of

such obligations in its own name and not as a fiduciary. Cardinal seeks to exercise its right to setoff the Cardinal Post-Petition Claim (defined below), which is entitled to administrative claim status, against the Graceway Post-Petition Claim (defined below).

4. Cardinal is also entitled to allowance of a rejection damages claim, arising from Graceway's rejection of the Agreements. This damage claim totals $5,683,557.36, as reflected in the proof of claim filed by Cardinal, a copy of which is attached hereto as **Exhibit D** (the "Rejection Damages Claim"). Exhibit D includes Claim Nos. 214 and 215 filed by Cardinal in the above captioned bankruptcy proceeding, which claims are identical. Under applicable law, Cardinal believes it is entitled to setoff it Rejection Damages Claim against the Graceway Prepetition Claim.

JURISDICTION

5. The Court has jurisdiction over this Motion pursuant to 28 U.S.C. §§ 157 and 1334. This matter is a core proceeding pursuant to 28 U.S.C. §§ 157(b)(1) and (b)(2)(A), (G), and (O). Venue of this proceeding and this Motion is proper in this District pursuant to 28 U.S.C. §§ 1408 and 1409.

6. The statutory predicates for the relief sought herein is 11 U.S.C. §§ 105, 362(d)(1), 503(b) and 553(a) and Fed. R. Bankr. P. 4001.

BACKGROUND

7. On September 29, 2011 (the "Petition Date"), the Debtors commenced these bankruptcy proceedings by filing voluntary petitions for relief under Chapter 11 of Title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq.* (the "Bankruptcy Code").

8. After filing for bankruptcy protection, the Debtors pursued a sale of substantially all of their assets pursuant to section 363 of the Bankruptcy Code. On November 22, 2011, an

Order was entered by this Court approving a sale to Medicis Pharmaceutical Corporation, LLC (the "Sale").

9. On February 28, 2012, the Debtors filed the Plan, amending an earlier version. The Plan is a liquidating plan. The confirmation hearing is currently set for April 11, 2012.

10. Prior to the Petition Date, in the ordinary course of business, Cardinal and Graceway entered into the Agreements In summary, the DSA, attached hereto as **Exhibit E**, provided that Cardinal would provide distribution services to Graceway in exchange for a fee. The WPA, attached hereto as **Exhibit F**, provided that Cardinal would purchase pharmaceutical products from Graceway for resale to various entities, including, but not limited to, hospitals, supermarkets, pharmacies, nursing homes, and clinics.

11. The business relationship between Cardinal and Graceway created a series of ongoing mutual payment and credit obligations between the parties. Cardinal incurred payment obligations to Graceway for the ongoing purchase of pharmaceutical products, while Graceway incurred payment and credit obligations to Cardinal for, among other things, distribution service agreement fees, Medicaid/Medicare rebates, chargebacks and product return credits. In the ordinary course of their dealings, Graceway settled such payment and credit obligations by issuing credit memos to Cardinal, who applied such credit memos against outstanding amounts owed to Graceway.

12. Prior to the Petition Date, Cardinal purchased pharmaceutical products from Graceway for which some payments remain outstanding. Similarly, Graceway issued to Cardinal prepetition credit memos which remain unapplied. On December 22, 2011, Cardinal filed Claim No. 144 with respect to its prepetition claims. The obligations owed to Cardinal from Graceway, as set forth in Claim No. 144, are valid and enforceable obligations, arising

prepetition in the ordinary course of business between the parties. Consistent with the course of dealings between the parties, its contractual rights under the Agreements and Section 553 of the Bankruptcy Code, Cardinal believes it may setoff the Cardinal Prepetition Claim against the Graceway Prepetition Claim.

13. After the Debtors filed for bankruptcy and up to the time of the Sale, Cardinal and Graceway continued their course of dealings under the terms of the Agreements. As a result, Cardinal owed amounts to Graceway on account of post-petition purchases of pharmaceutical products and Graceway owed certain amounts to Cardinal on account of distribution fees, chargebacks, rebates and product returns. It is Cardinal's position that the Cardinal Post-Petition Claim, which is entitled to administrative claim status, may be setoff against the Graceway Post-Petition Claim.

14. Effective December 31, 2011, the Debtors rejected the Agreements, as they were not part of the Sale. Thereafter, Cardinal filed Claim Nos. 214 and 215 asserting rejection damages. Cardinal believes that under applicable case law, its rejection damages claim should be allowed in full and setoff against the Cardinal Prepetition Claim.

15. In addition to Cardinal's setoff rights based upon the parties' course of dealings and their contractual rights which are preserved under section 553 of the Bankruptcy Code, Cardinal asserts a right of recoupment. The amounts owed to Cardinal by Graceway arise from the same transactions as the obligations of Cardinal to Graceway, and all such transactions were made pursuant to the Agreements.

RELIEF REQUESTED

16. Cardinal hereby moves pursuant to sections 105(a), 362(d)(1) and 553(a) of the Bankruptcy Code for entry of an order, substantially in the form attached hereto as **Exhibit A**,

(a) granting relief from the automatic stay to allow Cardinal to set off, or recoup as the case may be, the mutual obligations described above to the fullest extent permitted under applicable law, and (b) approving the same.[3]

BASIS FOR RELIEF REQUESTED

A. Cardinal Has Setoff Rights Under Applicable Ohio Law Which Section 553 Preserves.

17. Section 4.5 of the DSA and section 18 of the WPA each provide that they shall be governed by the laws of the State of Ohio. The right of setoff is of equitable origin and has been recognized as a right under both the statutory and common law of Ohio. *See* Ohio Rev. Code § 2309.19[4]; *Baker v. National City Bank of Cleveland*, 511 F.2d 1016 (6th Cir. 1975) (recognizing that the right of setoff is created by statute in Ohio). This right is rooted in the idea that "allow[ing] entities that owe each other money to apply their mutual debts against each other ... avoid[s] the absurdity of making A pay B when B owes A." *In re Semcrude, L.P.*, 399 B.R. 388, 393 (Bankr. D. Del. 2009) (internal citations omitted); *see also Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995) (same); *In re Bennett Funding Group*, 146 F.3d 136, 139 (2d Cir. 1998) (same). Moreover, setoff "is not dependent on the parties' contracts; rather, [it is an]

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[3] In the Debtors' Memorandum of Law in Support of Confirmation of the Debtors' First Amended Joint Plan of Liquidation of Graceway Pharmaceuticals, LLC, *et al.* Under Chapter 11 of the Bankruptcy Code the Debtors contend that Cardinal contractually waived its right of set off. As agreed with the Debtors, this issue will not be litigated at the plan confirmation hearing but rather within the context of this Motion. Suffice it to say that Cardinal vehemently disagrees with the Debtors. The parties' contracts taken as a whole as well as their course of dealings clearly demonstrate that Cardinal has a right of set off. Once the Debtors (and any other party in interest) articulate in greater detail their legal and factual position in a response to the Motion, then Cardinal will be in a position to file a more comprehensive reply to this waiver argument.

[4] "When cross demands have existed between persons under such circumstances that if one had brought an action against the other a counterclaim could have been set up, neither can be deprived of the benefit thereof by assignment by the other, or by his death. The two demands must be deemed compensated so far as they equal each other."

Ohio Rev. Code § 2309.19 (1953).

equitable remed[y] available independent of any contractual remedy." *CDI Trust v. U.S. Elec., Inc. (In re Commc'n. Dynamics, Inc.)*, 382 B.R. 219, 226 (Bankr. D. Del. 2008).

18. Section 553(a) of the Bankruptcy Code preserves any rights of setoff that may exist between a creditor and a debtor. *See Citizens Bank of Maryland*, 516 U.S. at 20 (As a general rule, "any right of setoff that a creditor possessed prior to the debtor's filing for bankruptcy is not affected by the Bankruptcy Code. . . ."); *Lawndale Steel Co. v. Magic Steel Co.*, 155 B.R. 990, 992 (Bankr. N.D. Ill 1993) ("A creditor with the pre-petition right of setoff does not lose its rights by failing to setoff before a bankruptcy petition has been filed."); *In re Bennett Funding Group*, 146 F.3d at 139 (bankruptcy courts have long required compelling circumstances to overcome enforcement of such right).

19. Courts have recognized a right of setoff in a bankruptcy provided that these conditions are met: (1) the creditor holds a claim against the debtor that arose prepetition; (2) the creditor owes a debt to the debtor that also arose prepetition; (3) the claim and the debt are mutual; and (4) both the claim and the debt are each valid and enforceable. *See* 11 U.S.C. §553(a); *In re Garden Ridge Corp.*, 338 B.R. 627, 633 (Bankr. D. Del. 2006); *In re Pardo v. Pacificare of Tex., Inc. (In re APF Co.)*, 264 B.R. 344, 354 (Bankr. D. Del 2001).

20. Setoffs in bankruptcy are favored and a presumption in favor of their enforcement exists. *See Kentucky Cent. Ins. Co. v. Brown (In re Larbar Corp.)*, 177 F.3d 439, 447 (6th Cir. 1999); *In re De Laurentiis Entm't Group Inc.*, 963 F.2d 1269, 1277 (9th Cir. 1992); *see also Junio v. Astoria Fed. Savs.*, 2002 U.S. Dist. LEXIS 25735, *24 (E.D.N.Y. 2002) ("Congress has acknowledged the "special status" historically accorded to the right of setoff, and the text of § 553 and the Code's legislative history suggest continued deference to the right of setoff."); *Bennett Funding Group*, 146 F.3d at 139 ("Cases under the prior Bankruptcy Act required

'compelling circumstances' to disregard state sanctioned setoff rights . . . injunction against a setoff is 'strong medicine.'") (internal citations omitted).

21. This Court has previously held that a rejection damages claim can be setoff against a prepetition debt owed to a debtor. *In re Commc'n. Dynamics*, 382 B.R. at 232. A rejection damages claim, as a claim stemming from the rejection of the Agreements, is a prepetition claim which can be setoff against debt owed by a creditor to a debtor. *See In re Commc'n. Dynamics*, 382 B.R. at 232 ("[F]or purposes of section 553, a rejection damages claim is a pre-petition claim subject to setoff against any prepetition debt owed by the creditor to the debtor.").

i. Cardinal and Graceway Hold Prepetition Claims Against Each Other.

22. As described above, Cardinal and Graceway have a longstanding business relationship for the purchase and distribution of pharmaceutical products. As a result of this relationship and in the ordinary course of business, Cardinal has a prepetition "claim" against Graceway as defined under Bankruptcy Code. *See* 11 U.S.C. § 101(5)(A). That claim is in the amount of $2,053,476.19 (the "Cardinal Prepetition Claim"). Attached as **Exhibit B** is documentation supporting the Cardinal Prepetition Claim.

23. Cardinal, in turn, owes money to Graceway as of the Petition Date for pharmaceutical products purchased by Cardinal. Thus, Graceway has a prepetition claim against Cardinal in the amount of $3,894,885.00.

24. As the Rejection Damages Claim arose pursuant to the Agreements, and is deemed a prepetition claim pursuant to the Bankruptcy Code, the funds owed by Cardinal to Graceway should be setoff by $5,683,557.36, the amount of the Rejection Damages Claim.

ii. Cardinal and Graceway Hold Post-Petition Claims Against Each Other.

25. As described above, Cardinal and Graceway continued their relationship after the filing of the Debtors' bankruptcy petitions. As a result of this relationship and in the ordinary course of business, Cardinal has a post-petition "claim", as defined under Bankruptcy Code, against Graceway. *See* 11 U.S.C. § 101(5)(A). That claim is in the amount of $1,070,527.84 (the "Cardinal Post-Petition Claim"). Attached as **Exhibit C** is documentation supporting the Cardinal Post-Petition Claim.

26. Cardinal, in turn, owes money to Graceway for pharmaceutical products purchased by Cardinal post petition. Thus, Graceway has a post-petition claim against Cardinal in the amount of $2,358,004.92 (the "Graceway Post-Petition Claim").

iii. The Obligations of Cardinal and Graceway Are Mutual.

27. The prepetition claim and debt owed between the creditor and the debtor must be "mutual" for Section 553 of the Bankruptcy Code to apply. 11 U.S.C. § 553(a). Courts have found that mutuality exists as long as the claim and debt are between the same parties, and the parties are acting in the same capacity. *See In re Semcrude*, 399 B.R. at 396, aff'd 2010 U.S. Dist. LEXIS 42477 (D. Del. Apr. 30, 210); *In re Szymanski*, 413 B.R. at 242; *In re Ne. Enters.*, 318 B.R. 625, 627 (Bankr. E. D. Pa. 2005). To meet the capacity requirement, the parties must each owe the other something in his or her own name, and not as a fiduciary. *In re Nuclear Imaging Sys., Inc.*, 260 B.R. 724, 735 (Bankr. E. D. Pa. 2000); *see also Semcrude, L.P.*, 399 B.R. at 396 ("each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally.") (internal quotations and citations omitted); *see also In re Garden Ridge*, 338 B.R. at 633 (same). Furthermore, mutuality will exist even though the obligations to be set off did not arise out of the same transaction "since the test

is mutuality, not similarity, of obligation." *In re Elsinore Shore Assocs.*, 67 B.R. 926, 936 (Bankr. D. N.J. 1986) (depository bank was permitted to set off its claim against the debtor for reimbursement under open letters of credit against amounts held in the debtor's general account at the bank).

28. The same debtor entity, Graceway, sold pharmaceutical products to Cardinal and issued credits to Cardinal for product returns, rebates, chargebacks, and distribution service fees, giving rise to these parties' respective claims. These parties' respective claims are reflected in the documentation attached hereto as **Exhibits B, C** and **D**. These mutual obligations arose in the ordinary course of their business dealings pursuant to the Agreements. Clearly, mutuality exists.

iv. The Obligations of Cardinal and Graceway Are Valid and Enforceable.

29. The prepetition claim and debt owed between the creditor and the debtor must constitute valid and enforceable obligations under applicable non-bankruptcy law in order for section 553 of the Bankruptcy Code to apply. *See In re Semcrude*, 399 B.R. at 393. Here, Cardinal's claim against Graceway and Graceway's claim against Cardinal are each valid and enforceable under the Bankruptcy Code and non-bankruptcy law. In the ordinary course of their business dealings and pursuant to the Agreements, Cardinal purchased products from Graceway. In connection with Cardinal's purchase of these pharmaceutical products, Graceway subsequently would be obligated to Cardinal for product returns, chargebacks, rebates and distribution service fees. Instead of making cash payments to Cardinal for amounts it owed to Cardinal, Graceway would issue credit memos to Cardinal to be applied to and deducted from amounts Cardinal owed to Graceway. Under this complex payment arrangement, each party was legally bound to make payment to the other.

B. Relief from the Automatic Stay Should be Granted to Permit Cardinal to Exercise its Valid Right of Setoff.[5]

30. Pursuant to section 362(d)(1) of the Bankruptcy Code, a party with an interest in property of the estate may request relief from the stay "for cause." 11 U.S.C. § 362(d)(1). As held by this Court in *In re Rexene Products Co.*, "cause may be established by a single factor such as a desire to permit an action to proceed ... in another tribunal, or lack of any connection with or interference with the pending bankruptcy case." 141 B.R. 574, 576 (Bankr. D. Del. 1992) (*citing* H.R. Rep. No. 95-595, 95th Cong., 1st Sess., 343-344 (1977)) (internal quotations omitted). The existence of the right of setoff alone constitutes "cause" sufficient to grant relief from the automatic stay to permit the setoff of mutual claims and debts. *See In re Nuclear Imaging Sys. Inc.*, 260 B.R. at 730 ("[c]ourts have generally concluded that the existence of mutual obligations subject to set-off constitute sufficient 'cause' to meet the creditor's initial evidentiary burden in seeking relief from the automatic stay"). A creditor can establish a prima facie showing of "cause" under section 362(d)(1) simply by demonstrating its right to setoff. *See Szymanski*, 413 B.R. at 243 ("[c]ourts generally recognize that, by establishing a right of setoff, the creditor has established a prima facie showing of 'cause' for relief from the automatic stay[.]") (*citing In re Ealy*, 392 B.R. 408, 414 (Bankr. E.D. Ark. 2008)); *see also In re Whitaker*, 173 B.R. 359, 361 (Bankr. S.D. Ohio 1994); *United States v. Parrish (In re Parrish)*, 75 B.R. 14, 16 (N.D. Tex. 1987) (reversing the denial of motion to lift stay where the creditor had established right to setoff).

[5] The Debtors' confirmation hearing on their chapter 11 plan is currently set for April 11. If a Plan is confirmed, the timing of the effectiveness of the Plan will dictate whether the automatic stay remains in place at the time of the hearing on this Motion. Regardless of the timing, given the disagreement between the parties on Cardinal's ability to setoff outstanding obligations, Cardinal will seek approval of the Motion from this Court.

31. Courts have broad discretion to lift the stay and should "balance potential prejudice to the bankruptcy debtor's estate against the hardships that will be incurred by the person seeking relief form the automatic stay if the relief is denied." *Robbins v. Robbins (In re Robbins)*, 964 F.2d 342, 345 (4th Cir. 1992). If the Motion is granted, Graceway will not suffer any prejudice, as it will be in the same position as it was prior to filing for bankruptcy protection. On the other hand, if the Motion is not granted, despite the clear right Cardinal has to setoff, Cardinal will be harmed.

32. Therefore, having established that Cardinal has an existing right of setoff under applicable law which is preserved under section 553(a) of the Bankruptcy Code, "cause" exists to grant relief from the automatic stay under section 362(d)(1) for the purpose of exercising such right.

C. Relief from the Automatic Stay Should be Granted to Permit Cardinal to Exercise its Valid Right of Recoupment, if Necessary.

33. The Third Circuit provided, in *Lee v. Schweiker*, 739 F.2d 870, 875 (3d Cir. 1984), that:

> Recoupment, on the other hand, allows the creditor to assert that certain mutual claims extinguish one another in bankruptcy, in spite of the fact that they could not be "setoff" under 11 U.S.C. § 553. The justification for the recoupment doctrine is that where the creditor's claim against the debtor arises from the same transaction as the debtor's claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation, and application of the limitations on setoff in bankruptcy would be inequitable.

34. The Third Circuit continued by stating "In bankruptcy, the recoupment doctrine has been applied primarily where the creditor's claim against the debtor and the debtor's claim against the creditor arise out of the same contract." Id. (citing *In re Sherman*, 627 F.2d 594 (2d Cir. 1980), and *Waldschmidt v. CBS, Inc.*, 14 B.R. 309 (M.D. Tenn. 1981)).

35. While Cardinal believes that its pre and post-petition claims against Graceway should be setoff against Graceway's claims of the same type, it may become necessary to exercise its right of recoupment in addition to its right of setoff. In this case, all of the amounts due to either party arise out of the Agreements. Thus, all post-petition payments that are otherwise ineligible for set-off should be netted under the recoupment doctrine.

WAIVER OF BANKRUPTCY RULE 4001

36. Cardinal respectfully requests that in the event the Motion is granted, that the stay under Rule 4001(a)(3) of the Federal Rules of Bankruptcy Procedure be waived such that the terms and conditions of the Order approving the Motion shall be immediately effective and enforceable upon its entry.

RESERVATION OF RIGHTS

37. Cardinal expressly reserves the right to amend or supplement this Motion or file a reply prior to or in connection with any hearing before the Court. Cardinal reserves all other rights.

38. No prior request for the relief sought herein has been made to this or any other Court.

NOTICE

39. This Motion is being served upon (a) counsel for the Debtors, (b) counsel to the Official Committee of Unsecured Creditors, (c) the Office of the United States Trustee, and (d) all parties that have requested notice in these chapter 11 cases pursuant to Rule 2002 of the Bankruptcy Rules. Cardinal submits that under the circumstances no other or further notice is necessary.

CONCLUSION

WHEREFORE, Cardinal respectfully requests that the Court grant the relief requested herein and such other and further relief as is just and proper.

Dated: April 10, 2012
Wilmington, Delaware

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