United States District Court

NORTHERN DISTRICT OF WEST VIRGINIA

UNITED STATES OF AMERICA,
Plaintiff,

V.

DAVIS MEMORIAL HOSPITAL and
ELKINS AREA MEDICAL CENTER,
Defendants.

JUDGMENT IN A CIVIL CASE

CASE NUMBER: 89-106-E

☐ **Jury Verdict.** This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ **Decision by Court.** This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that judgment be entered in favor of the defendants and against plaintiff on all counts in the Complaint pursuant to Rule 58 of the Federal Rules of Civil Procedure. Defendants' requests for attorney's fees and other costs are denied.

Defendant Davis Memorial Hospital's crossclaim against defendant Elkins Area Medical Center and defendant Elkins Area Medical center's renewed posttrial motion for involuntary dismissal are deemed moot.

September 4, 1990
Date

WALLY EDGELL, Ph.D.
Clerk

(By) Deputy Clerk

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IN THE UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF WEST VIRGINIA

Elkins Division

UNITED STATES OF AMERICA,

Plaintiff,

v.

DAVIS MEMORIAL HOSPITAL,
ELKINS AREA MEDICAL CENTER,

Defendants.

Civil Action No. 89-0106-E(K)

FINAL ORDER

This matter is before the Court for resolution subsequent to the August 13, 1990, bench trial of plaintiff's four claims against Davis Memorial Hospital ("Davis") and Elkins Area Medical Center ("EAMC"). Also before the Court is Davis's cross-claim against EAMC and EAMC's renewed motion for involuntary dismissal, pursuant to Rule 41(b) of the Federal Rules of Civil Procedure.

For the reasons stated in the accompanying Findings of Fact and Conclusions of Law, the Court hereby RULES in favor of defendants and against plaintiff and DIRECTS the Clerk to enter judgment in their behalf on all counts in the complaint, pursuant to Rule 58 of the Federal Rules of Civil Procedure. In light of the Court's ruling, DMH's crossclaim against EAMC and EAMC's renewed posttrial motion for involuntary dismissal are hereby

DEEMED MOOT. Defendants' requests for attorney's fees and other costs are hereby DENIED.

It is so ORDERED.

Let the Clerk send a copy of this Order to all counsel of record.

8/31/90
DATE

Richard L. Williams
UNITED STATES DISTRICT JUDGE

IN THE UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF WEST VIRGINIA

Elkins Division

UNITED STATES OF AMERICA,

Plaintiff,

v.

DAVIS MEMORIAL HOSPITAL,
ELKINS AREA MEDICAL CENTER,

Defendants.

Civil Action No. 89-0106-E(K)

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This matter is before the Court for resolution subsequent to the August 13, 1990, bench trial of plaintiff's four claims against Davis Memorial Hospital ("Davis") and Elkins Area Medical Center ("EAMC"). Also before the Court is Davis's cross-claim against EAMC and EAMC's renewed motion for involuntary dismissal, pursuant to Rule 41(b) of the Federal Rules of Civil Procedure.

By way of brief introduction, this case concerns two loans made to a hospital in Elkins, West Virginia, by two government agencies. The hospital had intended to merge with another competing hospital in the community because of an economic downturn in the locality's economy and changes in government third-party reimbursement schemes, which precipitated declining inpatient census. Although many steps were taken toward merger including the transfer of most of the hospital's assets, in which the government

had security interests, the proposed consolidation failed. Instead, the hospital sought bankruptcy protection. The government then brought suit against the other hospital and parent hospital corporation, which was to be formed, seeking damages.

On the basis of all the evidence introduced at trial and in the course of prior proceedings, the Court finds in favor of defendants and makes the following Findings of Fact and Conclusions of Law in accordance with Rule 52 of the Federal Rules of Civil Procedure. The stipulations of counsel are hereby incorporated by reference.

FINDINGS OF FACT

A. Parties and Procedural History

1. On July 18, 1989, the United States of America, suing on behalf of its agencies the Farmers Home Administration ("FmHA"), a division of the United States Department of Agriculture, the Economic Development Administration ("EDA"), a division of the United States Department of Commerce, and Charles E. Forsythe, District Counsel of the Small Business Administration ("SBA") in Clarksburg, West Virginia, and bond fund trustee for the EDA bonds at issue, filed a four-count complaint against Davis and EAMC.

Plaintiff filed an amended complaint on August 29, 1989. The four counts in the amended complaint are: 1) Tortious interference with contractual relations; 2) De Facto merger or consolidation; 3) Alter ego/Piercing the corporate veil; and 4) Tortious

impairment of collateral. The case was tried without a jury on August 13, 14, and 15, 1990, in Elkins, West Virginia.

2. Davis is a nonprofit hospital corporation organized under the laws of West Virginia, with its principal place of business in Elkins, West Virginia.

3. EAMC was at all relevant times a nonprofit hospital corporation organized under the laws of West Virginia, with its principal offices in Elkins, West Virginia. EAMC was incorporated on August 20, 1985, and dissolved on February 1, 1989.

4. Memorial General Hospital Association ("Memorial") was a nonprofit hospital corporation organized under the laws of West Virginia, with its principal offices in Elkins, West Virginia. On July 18, 1986, Memorial filed for bankruptcy protection under Chapter 11. With the exception of one of its divisions, the Elkins Convalescent Hospital ("ECH"), which was successfully reorganized as a separate corporation, Memorial no longer functions as a hospital corporation.

B. Chronology of Loan Agreements and Proposed Merger

5. On or about July 1, 1963, the EDA loaned Memorial $1,170,000, at an annual interest rate of 3.5 percent, by the purchase of a Series A Bond. The monies made available to Memorial were intended to enable the hospital to construct an acute care health facility.[1] [Stipulations of Fact, paragraph 1 (hereinafter

[1] It was in fact the Area Redevelopment Authority ("ARA"), a division of the United States Department of Commerce, which agreed in June of 1963 to make a grant in the amount of $2,430,000

"Stip., par.__"]

6. On or about July 1, 1966, the EDA loaned Memorial another $150,000, at an annual interest rate of 3.75 percent, by purchasing a Series B Bond. These monies, along with a grant in the amount of $350,000, were to be used for equipping the acute care health facility.[2] [Stip., par. 2]

7. The EDA's loans were secured by first liens on certain real estate belonging to Memorial, including the acute care building and the equipment contained within it, the ECH, the first $6,500 in revenues from Memorial's pharmacy operations, as well as other property.

8. Memorial made two requests for deferment of its loan repayments, one in 1975 and the second in 1979. The first deferment was extended to 1980, and its second request expired in 1984.[3]

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and a loan in the amount of $1,170,00 to Memorial for the purpose of constructing the acute care health facility.

In 1965, through passage of the Public Works and Economic Development Act, 42 U.S.C. § 3121, et. seq. (1982), Congress created the EDA as a division of the United States Department of Commerce and charged it with the responsibility of administering the Act. 42 U.S.C. § 3201, et. seq. (1982). The EDA assumed the functions previously performed by the ARA.

[2] Jack E. Corrigan, Regional Director of the EDA, in Philadelphia, Pennsylvania, testified at trial that under the public works program, the EDA often links loans to grants in order to fund the creation of its own collateral.

[3] Throughout this litigation, defendants have suggested that because the loans at issue were made at such low interest rates and were deferred and allowed to be in technical default, they were effectively government grants.

It is not for this Court, in this case, to question the soundness of the government's decision to make such loans, or to usurp its authority and convert them into grants.

9. In 1980, Memorial applied to the FmHA for a loan to be used to construct a physician's office building. On or about August 8, 1980, the FmHA loaned Memorial $3,603,000. To effect the loan agreement, the EDA subordinated its first lien position with respect to certain collateral. The FmHA took first lien position with respect to the Golden Medical Building (the physician's office building), its equipment, the equipment in the acute care facility, Memorial's accounts receivable, and other collateral. [Stip., par. 3]

10. As a result of the loan agreements between Memorial and the EDA and FmHA, the government possessed security interests in Memorial's real property, contract rights, accounts, general intangibles, gross receipts, gifts, pledges, income and revenue, supplies, inventory, furnishings, furniture, fixtures, equipment, machinery, motor vehicles, and all other tangible assets of every nature or description, including additions, substitutions, replacements, and accessions. The two agencies held a first lien on virtually all of Memorial's assets. [Stip., par. 4]

11. In the early 1980s, committees from Davis and Memorial discussed generally the possibility of combining their operations. No merger of any kind resulted from these discussions.

12. In 1983, the federal government implemented several changes in the method by which hospitals received third-party reimbursement, principally for Medicare patients. Prior to these changes, payors essentially reimbursed health care providers based upon the costs of the services required and rendered. After the

government's changes, third-party payors began reimbursing providers according to a fixed amount for the particular illness or diagnosis. Reimbursement schemes were adjusted according to diagnostic related groupings ("DRGs").

13. This change in the scheme of third-party reimbursement caused Memorial and Davis, like many other health care institutions, particularly in rural areas, to suffer declining inpatient census and revenues. Consequently, health care providers, like Davis and Memorial, were forced to focus their treatment of patients on outpatient and ancillary services.

14. Overall, Memorial was better situated than Davis to respond to the changing trends in the provision of health care. Memorial was a regional hospital consisting of an acute care center, a series of satellite health clinics, a skilled nursing facility for convalescent care, and various outreach programs. In addition, Memorial enjoyed an affiliation with a large group of specialized physicians, who were one of the hospital's primary sources for referrals. In contrast, Davis was a smaller hospital, not as fully equipped as Memorial. It was, however, managed exceedingly well, whereas Memorial seemed incapable of operating without a deficit. In fact, in 1985, before the alleged merger, Davis included among its assets $3 million in certificate of deposits.

15. By 1985, it became clearly evident to both Memorial and Davis that Elkins and Randolph County could not support two hospitals.

16. Thus, in April 1985, Thomas R. Ross, Chairman of Davis's Board of Trustees, contacted Grady F. Guye, Chairman of Memorial's Board of Directors, to discuss again the possibility of a merger of Davis and Memorial, despite the longstanding rivalry between the hospitals. Also in the spring of 1985, Ross and Guye appointed committees from their respective boards to pursue the possibility of consolidation.

17. Memorial and Davis exchanged some financial information during the Spring and Summer of 1985.

18. Davis, acting through its Chief Executive Officer, Robert Hammer, engaged an investment banking firm, John Nuveen & Co. ("Nuveen"), to study and provide assistance in evaluating the alternatives available to effect a combination with Memorial. Davis also requested and received from the West Virginia Health Care Cost Review Authority ("HCCRA") information regarding Memorial's financial condition. [Stip. par. 10.]

19. Nuveen asked Memorial to provide copies of Memorial's internal monthly financial statements, the legal documents governing Memorial's loans with the government, its charter and by-laws, and copies of its union contracts. After its financial analysis of Memorial, Nuveen concluded that Memorial had a market value of $9,202,000 and a net equity value of $2,438,000. Nuveen's analysis also revealed that Memorial was operating with a negative cash flow.

19. The merger committees of the two hospital boards first met on July 17, 1985.

20. On July 22, 1985, the chairmen of the boards of Memorial and Davis convened a meeting of the committees to hear a presentation by Timothy Schwertfeger, a vice president of Nuveen.

21. Mr. Schwertfeger reported on Memorial's financial difficulties and recommended that the consolidation effort, if pursued, be completed on an expedited basis. He further recommended that in order to obtain financing, it would be necessary to form a new corporation, which would have control over the management and operation of both hospitals. The merger plan envisioned that Davis and Memorial would be subsumed into the parent corporation, with the newly formed entity acquiring the assets of both hospitals.

Specifically, the proposal contemplated that the boards of both hospitals would consider for approval a resolution by which the two hospitals would agree to the merger and complete consolidation of the business affairs of both hospitals. The resolution would also approve of the execution of a consolidation agreement that would provide for the formation of a new not-for-profit corporation that would be the holding company of both hospitals, with the authority to appoint and replace members of the board of directors of Davis and Memorial.

The proposed consolidation agreement would provide that the initial board of directors of the parent company would have fifteen members, eight of which would be selected by the board members of Davis, seven of which would be selected by Memorial. Also under the agreement, Davis would provide capital for the

parent company in the amount of $500,000.

Mr. Schwertfeger also made it clear that the consolidation would be subject to the parent company obtaining a state Certificate of Need ("CON") and the approval of the federal government as required by Memorial's loan agreements.

Upon hearing Mr. Schwertfeger's presentation, the two committees agreed in principle to the concept of the consolidation. [Plaintiff's Exhibit 15; Testimony of Grady Guye]

22. Pursuant to the meeting and upon the recommendation of the doctors of Memorial's Golden Medical Group, the majority of Memorial's board requested confirmation of Memorial's financial condition. Thereafter, Ernst & Whinney, Memorial's accounting firm, reported that Memorial would indeed suffer an operating loss for fiscal year 1985 in the range of $1.2 million.[4]

23. Based in large part on Memorial's financial condition and the recognition that the community could not support two hospitals, Memorial's board authorized its chairman to execute an agreement, drafted by Joseph Wallace, counsel for Davis, entitled, "The Plan and Agreement of Consolidation Between Memorial General Hospital Association and Davis Memorial Hospital, Inc." (the "Merger Agreement"). Memorial signed the Merger Agreement on August 19, 1985, and Davis's chairman signed it on August 20, 1985.[5]

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[4] This loss is in contrast to the audited financial statements of Memorial prepared by Ernst & Whinney for fiscal year 1984 reflecting a profit of approximately $55,000.

[5] Prior to executing these contracts, the boards of Davis and Memorial resolved to amend their by-laws and articles of incorporation. The written resolutions provided that the chairmen

24. The Merger Agreement, itself, provides in Section 2.0 that "Upon the consolidation becoming effective: (2.1) The separate existence of MGHA (Memorial) and DMH (Davis) shall cease, . . . (and) (2.2) "New Corporation" shall thereupon and thereafter possess all the rights, privileges, immunities and franchises of MGHA and DMH, and all property, real, personal and mixed, . . . (and) (2.3) "New Corporation" shall henceforth be responsible and liable for all of the liabilities and obligations of each of MGHA and DMH." [Plaintiff's Exhibit 16]

25. Because Memorial had been concerned about public perception, the Merger Agreement provided, in lieu of the initial proposal, that there would be 15 trustees of the "New Corporation," consisting of seven members appointed by the president of Davis and seven members appointed by the chairman of Memorial. The fifteenth member was to be selected by the fourteen. The officers of the "New Corporation" were to be selected by the trustees. [Plaintiff's Exhibit 16]

26. The name of the "New Corporation" was Elkins Area Medical Center ("EAMC"). On August 20, 1985, Messrs. Ross and Guye filed EAMC's Articles of Incorporation with the West Virginia Secretary of State. That same day, the Secretary of State issued a Certificate of Incorporation for EAMC.

27. Each hospital also entered into an "Executive Management

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of the respective hospitals would execute the agreement of consolidation and that the parent corporation would have the authority to effect the consolidation. [Plaintiff Exhibits 20, 22, 23]

and Services Agreement," ("Management Agreement") with EAMC on August 20, 1985. The contracts provided that EAMC would provide to Davis and Memorial executive management services in consideration of the hospitals paying the costs incurred by the prospective parent for rendering such services.

28. While, undoubtedly, all those involved in the merger plan thought the consolidation was certain and the steps taken in furtherance of the merger irreversible, it was clear to both Davis and Memorial from the outset that HCCRA approval was necessary to effect the merger. [Testimony of Guye]

29. On August 20, 1985, at the first board meeting of EAMC, Thomas Ross was elected chairman of EAMC, and Grady Guye was elected vice chairman. John Busch, Memorial's attorney, was elected secretary, and Ralph Shepler was elected treasurer. Mr. Hammer of Davis was elected president and chief executive officer of EAMC, and Wayne Griffith of Memorial was appointed his assistant.[6] [Plaintiff's Exhibit 4]

30. The FmHA became aware of the Merger Agreement on August 18, 1985, when its agent Lawrence Betler was phoned by Mr. Wallace. Mr. Wallace, calling on behalf of Davis and EAMC, assured Mr. Betler that payments on the loans would continue to be made until the resolution of the merger. [Plaintiff's Exhibit 62] Mr. Betler

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[6] The names of the fifteen trustees appointed are: by Davis--Ashby Craft, James Patton, Thomas Ross, Ralph Shelper, A.C. Thompson, L.T. Williams, and Ralph Wilmoth; by Memorial--Grady Guye, Gloria Payne, Charles Bryant, John Busch, Ralph Hess, Ralph Mumme, and Stanley Masilamani. George Myles was appointed as the fifteenth member. [Plaintiff's Exhibit 4]

asked him for a copy of the Merger Agreement and a feasibility study.

31. On October 16, 1986, Mr. Betler met with Mr. Wallace and other representatives of EAMC. Mr. Wallace informed Mr. Betler that EAMC was in the process of filing an application with HCCRA and that it was conducting a feasibility study concerning the refinancing of Memorial's loans. The options of the study included, among other proposals, FmHA transferring the loans to EAMC, or refinancing both hospitals' debt with a new bond issue. [Davis's Exhibit 23]

32. Thereafter the position of the FmHA was a "wait and see" strategy, to the extent it may be called that.

33. The Court notes that Mr. Betler is a member of the community of Elkins, and at the time, shared in the hope and unequivocal belief that the merger would be effected.[7] This may have had some bearing on his course of action or inaction, but its significance is limited in light of the Court's ultimate ruling.

34. During the period between August 20, 1985, and July 1986, there were a series of events initiated in furtherance of the consolidation, the legitimacy of which the government challenges.

35. As originally conceived, the plans for consolidation called for the integration of the acute care operations of both

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[7] It is unclear how fully the government's agencies were apprised of the actions taken by both hospitals to bring about the merger. At trial, defense counsel for Davis implied that Mr. Betler was aware of the events leading to the failed merger, at least as they were reported in the community newspaper. It appears that the FmHA was aware of the transfer of medical equipment from Memorial to Davis. [Davis Exhibit 4]

hospital's at Memorial and the conversion of Davis's facility into a skilled nursing facility, primarily for elderly patients. ECH was to be sold, the proceeds of which were to be used to reduce the existing debt obligations of both hospitals.

36. In order to facilitate the consolidation and to establish a unitary hospital facility, EAMC's management formulated plans to renovate Memorial. The cost of these renovations were estimated to be $8 million.

37. On August 21, 1985, EAMC established its principle offices at Memorial.

38. Shortly thereafter, it became evident that Memorial's financial circumstances, particularly its problem with negative cash flow, were more dire than had been realized. Specifically, on August 28, 1985, Memorial informed EAMC that it did not have sufficient cash to meet its August 31, 1985, payroll.

39. In response to Memorial's need, EAMC obtained a $1,000,000 line of credit from Davis Trust Company. EAMC then loaned Memorial $728,000 to enable Memorial to meet its payroll and to pay back FICA taxes and union dues. According to Memorial's audited financial statements for fiscal year 1985, the $728,000 transfer is listed as a loan. [Plaintiff's Exhibit 108]

40. Acting pursuant to the Management Agreement, EAMC's CEO, Mr. Hammer, asked for the resignation of several of Memorial's high ranking executives, including, Mr. Griffith who had been Memorial's CEO, and Charlotte Hinkle, who had been Memorial's chief financial officer.

41. In addition to management reorganization and reduction of Memorial's staff, EAMC hired Arthur Young & Company to examine the status of and then liquidate Memorial's accounts receivable. Leslie Hampel, who at the relevant time in question was a principle with Arthur Young, testified that Memorial's accounts receivable were in a state of disarray. Accounts were horribly managed, and because Memorial had used a family billing system, as opposed to an individual billing system, the accounts were even more scrambled. Receivables were overstated, and debts were understated. The statute of limitations had run on many accounts.

42. In October of 1985, EAMC submitted an application to HCCRA seeking approval of the consolidation.

43. Effective November 1, 1985, upon the recommendation of Mr. Hammer, the emergency operations facility at Memorial was closed and transferred to Davis, in order to facilitate the renovations and minimize their cost. Although the emergency staff and equipment were transferred, the move was intended to be temporary, only until the renovations were completed. [Testimony Guye; Plaintiff's Exhibit 40][8]

44. At an emergency meeting held on November 30, 1985, Memorial's board resolved to consolidate its acute care operations at Davis's facility for an interim period of 18 to 24 months because of Memorial's continuing financial problems. On December 6, 1985, EAMC withdrew its October application to HCCRA and

[8] Mr. Guye testified at trial that at a hospital construction committee meeting, it was reported that if the hospital were empty during the renovations, the hospital would save $1 million.

converted it into an application to close Memorial. The HCCRA then authorized the temporary closure of the acute care facilities at Memorial.

45. In early 1986, at HCCRA's direction EAMC filed another application seeking approval of the consolidation. An amended application was filed on May 24, 1986.

46. On January 13, 1986, John Busch, legal counsel to Memorial, advised Memorial that the transfer of equipment did not violate Memorial's loan agreements with the EDA and FmHA. [Stip., par. 36]

47. In early March of 1986, Memorial's acute care operations were closed and equipment and staff were transferred to Davis on an "as-needed" basis.

48. The closure of the acute care facility served the goal of cost reduction, but it also caused Memorial to suffer a loss in revenues.

49. Davis obtained regulatory approval to expand temporarily its operation in order to accommodate the anticipated increase in patient care.

50. Shortly thereafter, Memorial's histology and psychology departments were transferred to Davis, and Davis's microbiology department was consolidated with Memorial's. The obstetrics-gynecology departments of both hospitals were to be consolidated at Memorial. The consolidation, however, never took place because Davis's equipment was pledged to secure preexisting loans and the agreements governing those loans prohibited such transfers and

because Memorial's unionized employees objected to the transfer.

51. In addition to the transfer of these departments, the purchasing departments of the two hospitals were combined at Davis's facility. The pharmacies were placed under the joint management of Pharm-C Consultants, and most radiology and laboratory services were combined with Davis's.

52. When employees were transferred, they were not required to reapply to Davis.

53. Over the next few months, other supplies, equipment and personnel were transferred to Davis from Memorial.

54. Prior to December 1985, there was no formal policy in place for keeping track of these transfers. Beginning in January of 1986, detailed records of transfers were maintained. [Davis' Exhibit 36; Plaintiff's Exhibit 57] Some records of transfers, however, were made in October 1985. [Plaintiff's Exhibit 57]

55. The title of these assets, however, was never transferred. [Davis Exhibit 7]

56. Also in December 1985, EAMC filed its application for a Certificate of Need ("CON") to the State Health Planning and Development Agency, Office of Health Planning and Evaluation, Certificate of Need program. [EAMC Exhibit 10]

57. Despite Mr. Ross's earlier assurances to the Golden Medical Group ("GMG") of physicians that it would remain intact, EAMC dismantled the group. Unlike the physicians at Davis, who maintained independent practices while enjoying hospital staff privileges, Memorial's physicians were on the hospital payroll.

While this affiliation encouraged referrals and generated revenues, it was costly for the hospital. In fact, plaintiff's expert testified that while only 37.6 percent of Davis's gross patient revenues ("gpr") went to salaries, 50 percent of Memorial's gpr went to employees' salaries. [Expert Testimony of Dr. Robert Taylor]

58. In summary, there is no question that the operations at Memorial were gradually phased out and transferred to Davis in furtherance of the proposed merger. Numerous government witnesses who were Memorial board members testified that they approved the transfers, believing that they were necessary to complete the merger.

59. There was simply no evidence at trial of malfeasance on the part of Davis or EAMC to plunder or otherwise harm Memorial.

60. Undoubtedly, these transfers eliminated any possibility that Memorial could recover from its already insolvent status, and most likely accelerated its financial demise. [Plaintiff's Exhibit 99] Although it supposedly received some revenues from patients treated at the Davis Memorial emergency room who would have been admitted to Memorial, this amount was never quantified for the Court. Regardless, the Court is convinced that Memorial's disastrous financial position was only made worse by the transfer of its assets to Davis.[9]

61. On June 12, 1986, HCCRA held a hearing on EAMC's May

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[9] This was not a concern to Memorial' board at the time because the plans for merger were considered irrevocable.

application. On July 9, 1986, Mr. Hammer reported to Memorial's board that the CON hearing had gone well and that he thought the HCCRA's determination would be favorable.

62. Also in June of 1986, EAMC retained the services of John Kamlowsky, a former bankruptcy judge, who was a private attorney. EAMC consulted him with respect to the relative advantages of Chapter VII and Chapter XI bankruptcy. He also assisted in the preparation of Memorial's bankruptcy petition.

63. Upon EAMC's recommendation and assurances that the merger would not be abandoned, Memorial's board resolved to seek Chapter 11 bankruptcy protection on July 17, 1986.

64. On July 18, 1986, Memorial filed a petition for reorganization.

65. The bankruptcy court appointed E. Lowell Markey as Examiner for the Memorial bankruptcy estate. The court later expanded Mr. Markey's powers to include those of examiner trustee.

66. Mr. Markey submitted his report on October 10, 1986. He concluded in the report, among other things, that no merger had taken place and that the prospects for Memorial were dim.

67. The EDA filed a proof of claim in the Memorial bankruptcy proceeding, in the amount of $1,697,826.34, representing $1,200,000 of unpaid principal and $497,826 of accrued interest. The FmHA, likewise, filed a proof of claim in the bankruptcy proceeding which stated that it had a claim as of the date of the bankruptcy in the amount of $3,342,328.41. [Plaintiff's Exhibits 1 and 2]

68. As part of the reorganization of Memorial, the bankruptcy court abandoned the acute care facility to the EDA. [Stip., par. 42]

69. On September 19, 1986, EAMC advised HCCRA of Memorial's bankruptcy petition and indicated that no further action on the pending application was needed.

70. In October 1986, the members of the EAMC board who also served on the Memorial board resigned from both boards due to their inability to obtain directors' and officers' liability insurance.

71. On October 10, 1986, Davis's board resolved to terminate the Merger Agreement and its Managing Agreement with EAMC. [Stip., par. 43]

72. EAMC dissolved effective February 1, 1989. [Stip., par. 46]

73. On July 18, 1989, the government filed suit.

C. Facts Relating to Plaintiff's Claims

74. The state regulatory conditions, specifically HCCRA approval and the issuance to EAMC of a CON, which were requisite to the consummation of the merger were never satisfied.

75. Financing for the consolidation was never obtained.

76. EAMC never filed articles of merger or consolidation with the West Virginia Secretary of State, and the Secretary of State never issued a certificate of merger or consolidation.

77. During the period between August 20, 1985, and July 18, 1986, the boards of Davis, Memorial, and EAMC operated

independently. Although there was a unity of purpose and common objective, the individual corporate form of each entity was maintained. There were individual board minutes and accounting records. [Plaintiff Exhibits 4, 5, and 6] Although not scrupulously, records of transfers of equipment, supplies, and funds were maintained. [Davis Exhibits 36, 37; Plaintiff Exhibits 57 and 108]

Undoubtedly, the business judgment of Memorial's board was predicated on facilitating the merger as expeditiously as possible. Although Memorial was susceptible to the recommendations of Davis and EAMC, the Court cannot say, however, that Memorial was dominated by EAMC or Davis, or that it had forfeited all autonomy. While many of Memorial's board meetings in that interim period may have been primarily for informational purposes, the board was not defunct in that it continued to vote on resolutions critical to the future course of Memorial.

Moreover, Memorial was at all times represented on EAMC's board. Although between November 14, 1985, and May 1, 1986, only one Davis representative resigned, while three of Memorial's representative resigned, Memorial's presence on the Board is undisputable. Furthermore, Memorial had the absolute right to replace the resigned board members and preserve the balance of equal representation, although it elected not to do so.[10]

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[10] Despite the government's attempt to prove that the EAMC board was dominated by Davis representatives, there was no evidence at trial that George Miles, the fifteenth and neutral member, was biased against Memorial, or unduly influenced by EAMC or Davis.

78. There is no question that Memorial was mismanaged, financially and administratively. Before the planned merger, the evidence is undisputed that Memorial had overwhelming cash flow problems, so significant at times that it was unable to meet its payroll. During the period when the three entities were trying to implement the merger, the Memorial board's management of its interests was also questionable. To the board's credit, it made many unsound business decisions because it thought that the merger was certain. This assumption explains why Memorial allowed the closing of its facility. Despite this assumption, however, the record is clear that the board members of Memorial fully understood that there would be no merger without state regulatory approval.[11] [Guye Testimony]

79. Also during the interim period between the signing of the agreements and the filing of bankruptcy, it was Memorial that continued to make payments on its debts to EDA and FmHA. Payments were expected from Memorial and not EAMC or Davis. [Testimony of Betler]

80. The FmHA was aware of the transfer of equipment from Memorial to Davis. [Davis Exhibit 4] Because there did not appear to the agency that there had been any changes in ownership or title of any of the property covered by the FmHA lien, it determined that

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[11] For fear of sounding too harsh, the Court notes that Elkins is a small community and that the members of Davis and Memorial's boards were colleagues and friends. Precautions that otherwise sophisticated corporations might take were absent here because of the presumption of trust between the players and the myopic hope that the merger was a foregone conclusion.

there was no need for any investigation at that time. [Davis Exhibit 7

CONCLUSIONS OF LAW

1. This Court has jurisdiction over this matter pursuant to 28 U.S.C. § 1345. Venue is proper under 28 U.S.C. § 1391(b) and (c).

2. Plaintiff has alleged four causes of action. Two are equitable in nature: 1) De Facto Consolidation/Merger and 2) Alter Ego/Piercing the Corporate Veil; the other two are tort claims: 3) Tortious Impairment of Collateral and 4) Tortious Interference with Plaintiff's Loan Contracts.

A. De Facto Consolidation/Merger

3. As a preliminary matter, all parties concede that a legal consolidation or merger was never achieved. Under West Virginia corporation laws, a merger or consolidation is effective upon issuance of a certificate of merger or consolidation by the Secretary of State. W.Va. Code § 31-1-37. EAMC never executed or filed articles of consolidation with the Secretary of State.

Mergers of health care institutions under West Virginia law require reissuance of a certificate of need. W.Va. Code § 16-2D-3(c). EAMC's application for a CON was withdrawn on September 19, 1986, therefore, no certificate was issued.

4. Whether there was a merger in fact is the question before the Court. Normally when a corporation acquires the assets of

another corporation it does not assume the liabilities of that corporation. There are a few exceptions where: 1) the acquiring corporation agreed, expressly or impliedly, to assume the acquired corporation's debts and liabilities; 2) there has been a de facto merger or consolidation of the acquiring and acquired corporations; 3) the acquiring corporation is a "mere continuation" of the acquired corporation; and 4) the acquisition was fraudulently executed to escape debts and liabilities. Crawford Harbor Assoc., Inc. v. Blake Constr. Co., 661 F.Supp. 880 (E.D.Va. 1987).

5. West Virginia has not expressly adopted the de facto merger or consolidation doctrines. In an Order dated February 13, 1990, the Court ruled that there are sufficiently analogous legal principles in West Virginia to support such a cause of action. See Carton v. West Virginia Bridge Const. Co., 183 F. 1009 (N.D.W.Va. 1910) (where two corporations fail in an attempt to effect a legal consolidation, but carry on their business together, such an arrangement is like a partnership, especially with respect to the rights of their creditors).

6. The de facto merger doctrine has been invoked "where one corporation takes all of another's assets without providing any consideration that could be made available to meet claims of the other's creditors." Crawford, 661 F.Supp. at 884, quoting Ray v. Alad Corp., 560 P.2d 3, 7 (1977).

7. There are several factors the Court may consider in determining whether there was a de facto consolidation or merger. These factors include whether there is/was: (a) continuity of the

enterprise of the seller corporation so that there is continuity of management, personnel, physical location, assets and general business operations (i.e., continuity of enterprise); (b) continuity of ownership; (c) a prompt cessation of the seller corporation's operations; or (d) an assumption by the purchaser of obligations ordinarily necessary for the uninterrupted continuation of normal business operations of the seller. Crawford, 661 F.Supp. at 884; Philadelphia Elec. Co. v. Hercules, Inc., 762 F.2d 303, 310 (3rd. Cir. 1985).

8. Each of the factors need not be proven. Rather, because this is an equitable doctrine, the Court must take all of the circumstances surrounding the proposed merger into consideration.

9. In this case the usual indicia of a de facto merger are simply not present. Although the merger agreement contemplated that EAMC would eventually assume the debts and liabilities of both Memorial and Davis upon the consolidation becoming effective, in the interim period, neither EAMC or Davis assumed the obligations necessary for the uninterrupted continuation of normal business operations.[12] While EAMC made a loan to Memorial to enable it to meet its payroll, neither Davis or EAMC, assumed, itself, Memorial's payroll or other creditor obligations. More significantly, neither EAMC or Davis assumed Memorial's debt

[12] The facts of this case are somewhat peculiar because Memorial contracted with EAMC to manage its business operations. This contract was for a fixed period of one year and respected the separate and distinct nature of the entities at that time.

obligations to the government. Although Mr. Wallace on behalf of EAMC or Davis assured the FmHA that payments would continue to be made, neither Davis or EAMC took upon itself the debt obligations.

10. Neither was there a prompt cessation of Memorial's corporate operations. If anything, Memorial's demise was a slow process, which gained momentum only as its financial cancer was diagnosed.

11. As for continuity of ownership and enterprise, these factors are not quite apposite. Because these were nonprofit organizations and there were no shareholders, there is no ownership to speak of. As far as continuity of enterprise is concerned, EAMC, the prospective parent company, managed both hospitals at the time in question. To that extent, both hospitals were managed by the same individuals. Nevertheless, the boards of all three remained distinct.

In the context of the prototypical de facto merger case, one corporation sells its assets to another. Here a merger was planned from the outset, but later abandoned. The more appropriate inquiry is whether the steps taken by the participating entities amounts to a merger in fact.

12. While the hospital entities and EAMC took many steps in furtherance of the proposed merger, the Court concludes that at all times the two hospitals and EAMC remained separate entities. Under the Merger and Management Agreements, Memorial, Davis, and EAMC all enjoyed a symbiotic relationship, which all hoped would culminate in the consolidation of the entities. As Memorial's financial

problems emerged, that relationship gradually became more parasitic, to the point that Davis could no longer afford to infuse money into Memorial and the merger venture.

B. Alter Ego/Piercing the Corporate Veil

13. This doctrine was adopted in West Virginia in Southern Electric Supply v. Raleigh County N.B., 320 S.E.2d 515 (W.Va. 1984).

14. The factors to consider in determining whether one corporation is the alter ego of another are: (a) Gross undercapitalization of the subservient corporation; (b) Failure to observe corporate formalities; (c) Siphoning off of the corporation's funds by the dominant corporation; (d) Commingling of assets; (e) Nonfunctioning officers or directors of the subservient corporation; (f) Absence of corporate records; (g) Common officers and employees and common facilities; and (i) Whether one corporation is merely a facade for the operation of the dominant entity. Keffer v. H.K. Porter Co., 872 F.2d 60 (4th Cir. 1989).

15. The Court must consider whether "recognition of the two entities as separate would result in an injustice." Iron City Sand & Gravel Division of McDonough Co. v. West Fork Towing Corp., 298 F.Supp. 1091 (1969), rev'd on other grounds, 440 F.2d 958 (4th Cir. 1971).

16. The factor of undercapitalization is not probative of this issue because Memorial appears to have been insolvent even

before it entered into its relationship with Davis and EAMC.

17. Corporate formalities were observed throughout the interim period when steps were taken to implement the proposed merger. Memorial, Davis, and EAMC all maintained separate boards, which in turn maintained separate board minutes. [Plaintiff Exhibit] In addition, the accounting for each entity was separate.

18. While many of Memorial's valuable assets were transferred to Davis, there was not a siphoning off of Memorial's funds. To the contrary, both EAMC and Davis infused money into Memorial.

19. Admittedly, there was some commingling of assets. For instance, Memorial's emergency facility was transferred to Davis before a formalized policy for tracking such transfers was implemented. In addition, some of Memorial's intangible or less tangible assets, such as referrals or in-patient admissions based on emergency room admissions were not well accounted for. Nevertheless, on the whole, Davis, Memorial, and EAMC' finances were separate and distinct.

20. Memorial was not exactly a subservient corporation; nor were its officers and directors nonfunctioning. As between Davis and Memorial, Memorial was the more vulnerable corporation. Because it had a negative cash flow and a history of poor administration, it was in a weaker position to dictate terms of management. That is not to say, however, that it was the subservient corporation. It had equal representation on the board of EAMC, which managed both hospitals. As the Court has already noted, the board members of Memorial, in their blind trust and

naive optimism, most likely breached their fiduciary duties to Memorial. That issue, however, is not before the Court today.

In sum, it appears to the Court that while the board members of Memorial were passive, in that they acquiesced to Mr. Hammer's management proposals, they were not "nonfunctioning." They functioned with good intentions, but poor business judgment.

21. The issue of separate corporate records has already been addressed by the Court.

22. There were undoubtedly common officers and employees and shared facilities. After Davis and Memorial entered into the Management Agreements with EAMC, and the CEO of EAMC asked for the resignation of Memorial's CEO, both Davis and Memorial shared the same CEO. Many of Memorial's employees became employees of Davis.

23. Although Memorial became an ineffective entity, in terms of the operation of a health care facility, it was not a mere facade for the operation of Davis or EAMC. Despite the financial pressures facing them, the board members of Memorial were still autonomous.

24. In consideration of all these factors and the totality of evidence, the Court concludes that neither Davis or EAMC was the alter ego of Memorial. While Memorial was influenced by the suggestions of Davis and EAMC, it was not a puppet corporation. The goal of achieving the merger dictated its actions and judgment.

C. Tortious Interference with Contractual Relations

25. West Virginia recognizes claims for tortious interference

with contractual relations. See Cotton v. Otis Elevator Co., 627 F.Supp. 519, 522 (S.D.W.Va. 1986), aff'd 841 F.2d 1122 (4th Cir. 1988).

26. The elements of the claim for tortious interference are: (a) the contract is between another and a third person; (b) the defendant(s) actually induced or otherwise caused the third person not to perform the contract; and (c) the defendant(s) intentionally and improperly interfered with the performance of the contract. Otis, 627 F. Supp. at 522.

27. Here the contracts at issue are between Memorial and the EDA and Memorial and the FmHA. For purposes of this analysis Memorial is the "third person."

28. The second element concerns causation--whether and to what extent Davis and/or EAMC's behavior caused Memorial's nonperformance.

29. In W.Va., "the proximate cause of an injury is the superior or controlling agency from which springs the harm, as contradistinguished from those causes which are merely incidental or subsidiary to such principal and controlling causes." Lilly v. Taylor, 155 S.E.2d 579, 589 (W.Va. 1967).

30. The question in this case is whether Davis and/or EAMC's actions with respect to the merger and its eventual abandonment by Davis were the controlling cause of Memorial's default on the loans.[13] Memorial was in dire financial straits, even prior to

[13] Defendants introduced evidence at trial and throughout the course of this litigation which established that Memorial had been in technical default. That fact does not affect the outcome of

August 20, 1985. Although it's not certain whether or not Memorial could have repayed the loans, regardless, it was clear that once its major assets were transferred to Davis, all hopes for repayment were dashed. Moreover, the Court concludes that it was the board of Memorial's poor judgment which resulted in its default on its loans.

31. The Court thus concludes that it was Memorial's catastrophic financial state that caused its demise and ultimate nonperformance. That was the controlling agency. To the extent that the transfer of its emergency and acute care facilities, as well as other assets, accelerated Memorial's downfall, the Court concludes that Memorial was as much to blame for the imprudent transfers as Davis and EAMC.[14]

32. While the government argues that Davis and EAMC pressured Memorial into surrendering its assets, under the guise of effectuating the merger, the Court concludes that the evidence introduced at trial does not support such a conclusion.[15] Memorial

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this case, especially given the fact that the EDA loan was a public works loan, a kind which the government rarely, if ever, forecloses on. [Testimony of Corrigan]

[14] If, indeed, Davis and EAMC induced Memorial to make these imprudent decisions by chicanery or fraud, the government failed to offer any such proof. On the face of the evidence, it appears that Memorial, Davis, and EAMC pursued merger in good faith, undertook steps to bring about consolidation, but discovered Memorial's financial problems were too great an obstacle.

[15] While Davis and EAMC may have exploited Memorial's eagerness and need to consolidate, the government failed to prove any misconduct on the part of either entity. For instance there was no direct evidence that Davis and EAMC never intended to merge with Memorial, or that the planned merger was proposed to strip Memorial of its assets.

willingly entered into the Merger Agreement and transferred its assets to Davis.

33. The third element considers Davis and EAMC's intent. Plaintiff must show that the Davis and/or EAMC purposefully, knowingly, and without justification induced Memorial to breach its contract with the government. International Union, UMWA v. Eastover Mining Co., 623 F.Supp. 1141, 1146 (W.D.Va. 1985).

34. The government failed to prove that Davis or EAMC induced Memorial to breach its contracts with the government. Although the government suggested that Davis and EAMC had a scheme to induce Memorial to transfer its emergency and acute care facilities to Davis, with the intention of abandoning the merger, it failed to prove its hypothesis. In essence the government has asked the Court to infer that because Davis abandoned the merger and EAMC was dissolved, Davis and EAMC planned all along to ruin Memorial for their gain. While the Court could infer that, it could also infer that the merger was pursued with the best intentions, but in the end became financially impossible. In short, the government failed to meet its burden of proof.

D. Tortious Impairment of Collateral

35. Although there is no West Virginia case exactly on point, the Supreme Court of West Virginia recognizes the defense of unjustified impairment of collateral under the Uniform Commercial Code. Peoples Bank of Point Pleasant v. Pied Piper Retreat, Inc., 209 S.E.2d 573 (1974).

36. Perhaps more helpful to the Court is the analogous cause of action, conversion, which is recognized in West Virginia.[16]

37. Under West Virginia law, the tort of conversion requires proof of a "distinct act of dominion wrongfully exerted over the property of another and in denial of his rights, or inconsistent therewith." Miami Coal Co. v. Hudson, 332 S.E.2d 114, 121 (W.Va. 1985).

38. To establish a prima facie case for the tort of conversion, the government must prove: (a) the government's loans were secured by collateral; (b) EAMC and/or Davis wrongfully asserted dominion over the pledged collateral; (c) the conduct of Davis and/or EAMC caused damage to the government's collateral; and (d) the government's right to the collateral was impaired. Miami Coal, 332 S.E.2d at 121.

39. It is undisputed that the EDA and FmHA loans to Memorial were secured by collateral.

40. As for the second element, the Court concludes that neither Davis or EAMC wrongfully asserted dominion over the pledged collateral. Prior to the transfer of the collateral, Memorial's counsel, John Busch, wrote an advisory opinion concluding that the transfer of equipment did not violate Memorial's loan agreements with the EDA and FmHA. [Stip. par. 36]

Furthermore, Memorial acquiesced in the transfers and determined such transfers to be in the best interest of Memorial.

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[16] The Court has already noted this analogy in its Order of February 13, 1990.

Thus, while Davis had dominion over the collateral, it was not wrongfully asserted. In fact, Davis eventually purchased for $400,000 certain property that had been transferred from Memorial to Davis, and the government signed a release with respect to that property. [Stip. to Exhibits][17]

41. Turning now to the third element of this cause of action. It appears that there was some damage to the government's collateral by virtue of its transfer. Because equipment was hastily removed, there was some damage to the structure of the Memorial facility. This consequence did not seem dire at the time since renovations were intended.

On the other hand, the transfer of collateral was done pursuant to a proposed plan that ultimately would have enhanced the collateral.

42. The government's right to the collateral was not impaired. It is undisputed that the government knew of the whereabouts of its collateral. In fact, even after Memorial's property was transferred to Davis, the FmHA did not protest the transfers. [Davis Exhibit 7]

In summary, the Court finds that the government has failed to meet its burden of proof with respect to all four claims. Throughout the period in question, Memorial, Davis, and EAMC were separate and distinct entities, striving for a unitary goal. Although the combined decisions and actions of all three entities

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[17] The order of the bankruptcy court permitting the sale and a copy of the bill of sale were proffered to the Court on August 31, 1990.

significantly advanced them toward their goal, the Court concludes that there was no legal or de facto merger of the three entities.[18] Nor is there sufficient evidence to conclude that Davis or EAMC was the alter ego of Memorial. With respect to the tort claims, again, the government's proof was insufficient.

For the foregoing reasons, the Court hereby RULES in favor of defendants and against plaintiff and DIRECTS the Clerk to enter judgment in their behalf on all counts in the complaint, pursuant to Rule 58 of the Federal Rules of Civil Procedure. In light of the Court's ruling, DMH's crossclaim against EAMC and EAMC's renewed posttrial motion for involuntary dismissal are DEEMED MOOT. Defendants' requests for attorney's fees and other costs are hereby DENIED.

It is so ORDERED.

Let the Clerk send a copy of the Court's Findings of Fact and Conclusions of Law and the accompanying Order to all counsel of record.

8/31/90
DATE

Richard C. Williams
UNITED STATES DISTRICT JUDGE

[18] Specifically the Court means that there was no de facto merger of Memorial and Davis, or of Memorial and EAMC.