

Bankruptcy Section 506(c) Surcharge on Secured Collateral

Seeking or Defeating Recovery of Expenses for Preserving or Disposing of Collateral

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Today's faculty features:

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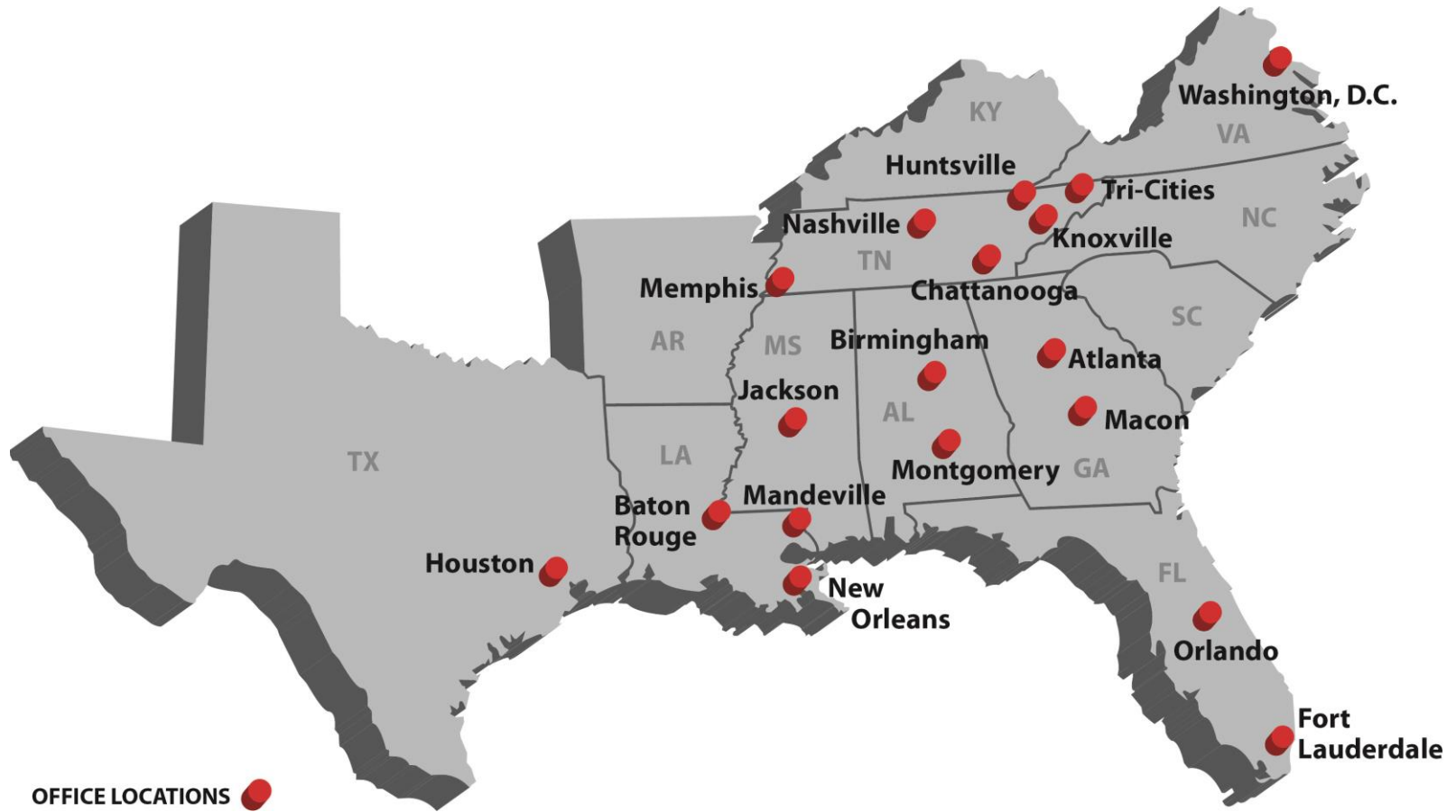
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Section 506 Collateral Surcharge

Erno Lindner
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I. Background

- Under § 506(c) of the Bankruptcy Code, a trustee “may recover from the property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.” 11 U.S.C. § 506(c).
- To prevent a windfall to a secured creditor at the expense of the estate *See, e.g., In re JKJ Chevrolet, Inc.*, 26 F.3d 481, 483 (4th Cir. 1994) (“The purpose of [§ 506(c)] is to prevent a windfall to a secured creditor at the expense of the estate.”).

II. Exception to the rule

- *In re Smith Intern. Enterprises, Inc.*, 325 B.R. 450, 453 (Bankr. M.D. Fla. 2005) (“Surcharging collateral subject to a security interest is the exception and not the rule for recovering costs and expenses associated with the preservation or disposition of estate property. Ordinarily, the costs and expenses detailed in Section 506(c) are paid from the unencumbered assets of a bankruptcy estate rather than from secured collateral”).
- Party seeking a surcharge faces an “onerous” burden of proof.

II. Exception to the rule (continued)

- Section 506(c) cannot be used as a substitute to recover ordinary administrative expenses incurred in the administration of the bankruptcy estate.
- Narrow construction § 506(c) = only expenses properly identified as incurred primarily for the benefit of the affected secured creditor may be charged against that secured creditor.

III. Standing Issues

- Prior to U.S. Supreme Court's decision in *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, split of authority on whether administrative expense creditors had standing to seek recovery of costs under § 506(c).
- NOW: § 506(c) is a reimbursement provision for the benefit of the estate, not for any other claimant and only a trustee or a debtor-in-possession with the powers of a trustee may surcharge collateral for preservation costs
- The trustee is obligated to seek recovery under § 506(c) “whenever his fiduciary duties so require.” 530 U.S. at 13.

III. Standing Issues (continued)

- Court declined to address the issue of derivative standing.
- Since only the trustee can seek a recovery under § 506(c), derivative standing for other parties is inappropriate. See, e.g., *In re Debbie Reynolds Hotel & Casino, Inc.*, 255 F.3d 1061, 1068 (9th Cir. 2001)
- BUT does not prevent derivative suits to bring § 544 avoidance actions. See *In re Trailer Source, Inc.*, 555 F.3d 231, 245 (6th Cir. 2009).

IV. Procedure

- By a motion or adversary complaint.
- Must notice secured creditor.
- Core proceeding.
- *In re Felt Mfg. Co., Inc.*, 402 B.R. 502 (Bankr. D. N.H. 2009) (language in financing order that precluded any surcharge of collateral of lender was not a waiver of estate's right to pursue surcharge claim).

IV. Procedure (continued)

- *In re EWI, Inc.*, 208 B.R. 885 (Bankr. N.D. Ohio 1997) (the court allowed a cash collateral carve-out provision authorizing the surcharge of a financial advisor's fees and expenses).
- Once property sold bankruptcy court no longer has jurisdiction to surcharge the collateral.
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- AND Once a Chapter 11 plan has been confirmed unless the plan preserves right.

V. Burden of Proof

- Party seeking recovery – must demonstrate all elements

VI. Amount of Recovery

- Limited to the extent of the benefit conferred on the secured creditor.
- Recovery not dependent on the secured creditor's status as over secured
- BUT courts are less likely to surcharge where the secured party is over secured – necessity may be lacking.

VII. Elements of Recovery

- In order to recover under § 506(c), the trustee must show three elements: (1) that the expenditure was **necessary**; (2) that the expenditure was **reasonable**; and (3) that the secured creditor received a **benefit** from the expenditure.
 - **Consent**
 - Need not show necessity, reasonableness, or benefit to the secured party
 - Express and clearly stated
 - BUT can be implied from conduct

VII. Elements of Recovery (continued)

- Consent to some expenses is not blanket consent
 - Other examples
 - Conditions to surcharge that must be satisfied in the absence of secured creditor consent
- **Reasonable**
- Amount that would have been incurred by the secured creditor in foreclosing on its collateral.
 - Reasonableness of attorney's fees

VII. Elements of Recovery (continued)

- **Benefit to Secured Creditor**
 - Need proof that the secured party received over and above the amount the creditor could have realized without the expenditure by the trustee. *See, e.g., In re Crutcher Concrete Const.*, 218 B.R. 376, 380–81, (Bankr. W.D. Ky. 1998) (“To demonstrate such a benefit, the Trustee must show that the secured creditor received over and above that which it could have realized without the Trustee’s intervention.”)
 - The benefit must be direct and substantial, and not incidental. *Cascade Hydraulics*, 815 F.2d at 548 (“A debtor does not satisfy her burden of proof by suggestion hypothetical benefits.”).

VII. Elements of Recovery (continued)

- Must benefit secured creditor and not the estate generally.
- Examples.

– **Necessity**

- There is equity in the collateral for the benefit of the estate
- Expense was unavoidable to preserve or dispose of the collateral or increase its value.
- Examples: appraisal fees; auctioneer fees; storage costs; advertising costs; employee fees; maintenance and repair costs; and marketing costs.

VII. Elements of Recovery (continued)

- **In re TIC Memphis RI 13, LLC**
 - “Where actions are elective and forgo other viable actions and options, such actions are not . . . by nature necessary.”
 - Actions performed are substantially similar actions to what the secured lender would have taken
 - “[R]easonableness in and of itself does not infer necessity, as one can have reasonable elective actions just as one can have reasonable necessary actions.”

VII. Elements of Recovery (continued)

- “Had the Debtor filed for chapter 11 relief and sold the asset for more than the payoff amount, the Debtor and its professionals would have reaped the benefit. However, the Debtor cannot avoid the dire consequences of its gamble when that gamble loses.”
- Surcharge typically reserved for situations of imminent loss
- “Where the secured creditor in hindsight would not seek the same or substantially similar benefit if placed in the same position of the trustee or debtor in possession, the court is hard pressed to find that a benefit for the secured creditor resulted.”

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