SOUTHEASTERN BANKRUPTCY LAW INSTITUTE:
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SECTION 506(c) SURCHARGE OF COLLATERAL

Presented by

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April 14-16, 2005

Southeastern Bankruptcy Law Institute

SECTION 506(c) SURCHARGE OF COLLATERAL

I. Standing of Debtor, Trustee, and Other Creditors or Parties in Interest to Seek Surcharge

- Under § 506(c), the trustee may surcharge a secured creditor's collateral for "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).
- Only the trustee or debtor in possession (asserting the rights of a trustee) has standing to surcharge collateral. See *Hartford Underwriters Insurance Co. v. Union Planters Bank*, 530 U.S. 1 (2000).
- The trustee is obligated to seek recovery under § 506(c) "whenever his fiduciary duties so require." 530 U.S. at 13.
- There is disagreement among the Circuits as to who owns the § 506(c) recovery, even though standing is the exclusive province of the bankruptcy trustee. (The issue was left open by the Supreme Court.)
    i. The Fourth Circuit has connected standing in the trustee with ownership of the right to recovery in the bankruptcy estate. *Ford Motor Credit Co. v. Reynolds & Reynolds Co. (In re JKJ Chevrolet, Inc.)*, 26 F.3d 481 (4th Cir. 1994).
    ii. The Ninth Circuit has held that, even though the trustee has exclusive standing to bring the § 506(c) claim, the recovery can be assigned directly to the § 506(c) provider and that "a § 506 surcharge is not an administrative claim, but an assessment against a

secured party's collateral." *Debbie Reynolds Hotel & Casino, Inc. v. Calstar Corp., Inc. (In re Debbie Reynolds Hotel & Casino, Inc.)*, 255 F.3d 1061, 1067 (9th Cir. 2001).

- Parties who provide services to preserve collateral for the benefit of the trustee can protect themselves through the mechanism of imposing contractual obligations imposed on the trustee in the ordinary course of business; query, can they obtain a lien without a court order in view of § 362(a)(4)?
- The trustee and the claimant have more leverage to arrange payment under § 506(c) at the outset of the proceeding, by refusing to maintain collateral absent consent in advance of the secured creditor to reimbursement of the expenses.
- If the secured creditor pays a third party directly, its security agreement will likely give it the right to add the (reasonable) costs to its secured claim.

II. Express or Implied Consent of Secured Creditor

- The secured creditor must be benefited in a tangible, direct way for a surcharge to be proper, unless the creditor consents to the surcharge.
- There is a divergence in the case law as to whether consent must be express, or whether it can be implied by failure to object to actions taken by a trustee.
- Contract law, and not § http://web2.westlaw.com/find/default.wl?DB=1000546&DocName=11USCAS506&FindType=L&AP=&mt=Westlaw&fn=_top&sv=Split&vr=2.0&rs=WLW5.01506(c) applies where the secured creditor directly pays a third

party to protect or preserve its collateral. However, if the trustee contracts for the service without the secured creditor's consent, the trustee must proceed on the basis of § 506(c).

- Implied consent is "not to be lightly inferred." *General Electric Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 77 (2d Cir.1984) (*Flagstaff I*) and *In re Flagstaff Foodservice Corp.*, 762 F.2d 10 (2d Cir. 1985) (*Flagstaff II*); *In re Pudgie's Development of NY, Inc.*, 239 B.R. 688, 698 (S.D.N.Y. 1999), noting that the secured creditor did not consent because it "in no way caused the expense."
- If the secured creditor consents, or directly causes the costs to be incurred, there is no requirement of a direct benefit to the creditor.

III. Conditions to Surcharge that Must be Satisfied in the Absence of Secured Creditor Consent

- In order for costs to be recoverable under § 506(c), the following criteria must be met:

  (1) The expenditures or services must be necessary.

  (2) The amount of the expenditures or services must be reasonable.

  (3) The expenditures must confer a direct benefit upon the secured creditor.

  11 U.S.C. § 506(c).
- The party making the claim under § 506(c) must establish in quantifiable terms that the funds were expended to protect and preserve the collateral. *In re Visual Industries, Inc.*, 57 F.3d 321, 324 (3rd Cir. 1995).
- The claimant must prove that the expenditure benefited the creditor and that this was a primary motivation of the movant's actions. One Circuit Court

has stated that "a debtor does not meet his burden of proof by suggesting possible or hypothetical benefits." *Flagstaff II*, 762 F.2d at 12.

- The following have been deemed "reasonable and necessary" under case law: use and occupancy charges, security and utility expenses, broker's fees, auctioneer fees, storage charges, costs of sale, costs of maintaining, harvesting and marketing crops. However, if the expenses do not increase the secured party's recovery or eliminate expenses that the secured creditor would otherwise bear, § 506(c) may not apply.
- Costs normally not deemed to be "reasonable and necessary" in the surcharge context include: general administrative costs, overhead, the statutory commissions of the trustee, and the value of labor of the debtor, unless it can be shown that there was a resulting direct benefit to the secured party or that the secured party consented to the charge.
- The broad range of costs for which some lower courts have permitted the application of § 506(c) has been the source of some lender concern. However, appellate courts have to a large extent limited the surcharge remedy by overturning attempts to give a broad reading to the Code's language at the expense of secured creditors.

IV. Surcharge to Pay Post-Petition Professional Fees

- Payment of administration expenses traditionally has been the responsibility of the debtor's estate, not its secured creditors. *Flagstaff I*, 739 F.2d at 77.
- Only if expenses for the preservation or disposition of property are incurred primarily for the benefit of a creditor holding a security interest in the property may such expenses be charged against the secured creditor. *Id*.

V. Surcharge to Pay Post-Petition Payroll Taxes

- In *Flagstaff II*, the court denied surcharge recovery for payment of payroll taxes, rejecting the assertion that payment of the taxes contributed to reorganization and increased the going concern value of the assets. The court required the debtor to "show that its funds were expended primarily for the benefit of the creditor and that the creditor directly benefited from the expenditure." *Id.* at 12.

VI. The Propriety of § 506(c) Waivers in Initial Loan Documentation, Workout Documentation, and Cash Collateral and Post-Petition Financing Orders

- Section 506(c) poses a risk for pre-petition lenders, and many attempt to include anti-surcharge language in DIP financing orders as a condition to the DIP financing.
- The validity of anti-surcharge provisions has been questioned, to the extent the provision attempts to shield a DIP lender's pre-petition collateral from surcharge. *In re Willingham Investments, Inc.*, 203 B.R. 75, 79 (Bankr. M.D.Tenn. 1996) (holding that DIP lender could not immunize its pre-petition secured interests from surcharge under § 506(c)). The § 506(c) waiver may be viewed as impairing an important right belonging to creditors which cannot be waived without adequate notice to creditors and an opportunity to be heard.
- Financing orders often contain provisions delegating certain rights to the creditors' committee or to creditors generally. The Supreme Court's decision in *Hartford Underwriters* leaves somewhat uncertain whether the

debtor's standing under § 506(c) can be delegated to the creditors' committee or any other entity. See also, *The Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics)*, 330 F.3d 548 (3d Cir. 2003) (en banc), *cert. dismissed*, 124 S.Ct. 530 (2003).

- The Financing Guidelines of the United States District Court, Southern District of New York, provide that waivers under § 506(c) in DIP Financing Orders are considered "Extraordinary Provisions" and must be pointed out to the court and other parties when sought. The motion and any accompanying order must conspicuously disclose the "Extraordinary Provisions" and justification for them must be separately set forth. Such extraordinary relief ordinarily will not be approved in interim and emergency orders, "without substantial cause shown, compelling circumstances and reasonable notice." General Order M-274, p. 3.

VII. Ability to Surcharge a Secured Creditor Directly or Just its Collateral

- Section 506(c) creates only a non-recourse claim; therefore, the trustee may recover only from property and not from the secured claimant *in personam*.
- As a result, if the collateral becomes worth less than the amount sought to reimburse the estate for the cost of repairs, the trustee can collect only to the extent of the value of the collateral.

This outline on § 506(c) draws on the following published sources, which may also be referenced for further information:

Martin J. Bienenstock, "Recent Developments Affecting Chapter 11 Cases," 862 PLI/ Comm 337, 341, (April - May 2004).

David Gray Carlson, "Surcharge and Standing: Bankruptcy Code Section 506(c) After Hartford Underwriters," 76 Am. Bankr. L.J. 43 (Winter 2002).

Michael L. Cook, Jeffrey S. Sabin, "Business Reorganization Financing – 2004," 863 PLI/Comm 31 (April – May 2004).

Marcia L. Goldstein, Michele J. Meises, and Timothy Graulich, "Current Issues in Debtor in Possession Financing," 867 PLI/Comm 251 (October 2004).

Steve H. Nickles and Edward S. Adams, "Tracing Proceeds to Attorneys' Pockets (and the Dilemma of Paying for Bankruptcy)," 78 Minn. L. Rev. 1079 (May 1994).

Arnold M. Quittner, "Employment and Compensation of Professionals," 838 PLI/Comm 827 (April 11, 2002).

N. Neville Reid, Amy S. Korte, "Debtor-in-Possession Financing and Operations Under the United States Bankruptcy Code," 863 PLI/Comm 7 (April-May 2004).

Thomas J. Salerno, Roger K. Ferland, and Craig D. Hansen, "Environmental Law and Its Impact on Bankruptcy Law – Saga of 'Toxins-R-Us," 25 Real. Prop. Prob. & Tr. J. 261 (Summer 1990).