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Surcharges in Bankruptcy - A Risk You Can Plan For?

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The Bankruptcy Code is a balancing act with each section promoting one or more of three competing principles: the protection of a secured creditor's property rights, equitable and equal distribution to unsecured creditors or the debtor's fresh start. Section 506(c) is a counter weight designed to balance the need for an equitable distribution to unsecured creditors with the secured lender's right to realize the value of its collateral. Ordinarily, in order to protect the secured lenders' interest in its collateral, unsecured creditors, including the administrative creditors, must look only to the unencumbered assets of the bankruptcy estate to seek payment. However, Section 506 (c) is the exception to that rule and offers a "surcharge" on the collateral of a secured lender when efforts by or on behalf of the bankruptcy estate clearly benefit the secured lender rather than the estate generally. Thus, the section provides that the trustee (or the debtor in possession) may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, the secured property to the extent of any benefit to the holder of such claim.

The language of the section on its face does not appear complex, but it took until 2000 to settle that only the trustee or the debtor in possession had standing to assert the cause of action. See *Hartford Underwriters Insurance Company v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S. Ct. 1942 (2000). Despite that ruling, there appears to be some case law indicating that such claims can or should be asserted derivatively for the benefit of particular creditors. But see *In Re Resource Technology*, 356 BR 435 (Bankr. ND Ill. 2006) wherein the Court after reviewing the reasoning of *Debbie Reynolds Hotel & Casino*, 255 F3d 1061 (9th Cir. 2001) properly decided in light of the Supreme Court's reasoning in *Hartford Underwriters* that any claim under 506 (c) must not only be asserted by the trustee but must also benefit the estate rather than any particular creditors.

The surcharge, absent the consent of the secured creditor must be for "reasonable, necessary costs and expenses" and the majority view is that the collateral should not be surcharged unless there is a direct and quantifiable benefit to the creditor. See *In re Cooper Commons LLC*, 512 F.3d 533 (9th Cir. 2008) and *Evanston Beauty Salon Supply, Inc.*, 136 BR 171. (Bankr. N.D. Ill 1992). Generally, the courts have recognized that the benefit should be specific to the collateral and not simply a contribution to the general costs of the operation of the estate. It appears that most courts apply a relatively strict standard in determining what constitutes a benefit to a secured creditor, but there are instances where the court surcharged the collateral for amounts expended to continue the debtor's operations as the bankruptcy court did in *In Re Machinery, Inc.*, 287 BR 755 (Bankr. E.D. Mo 2002). Although older cases offer comfort that mere acquiescence should not constitute consent, see *In Re: Flagstaff Services,* 739 F2d 73 (2nd Cir. 1984) or *In Re Compton Impressions Ltd.*, 217 F3d 1256 (9th Cir. 2000), there are some instances where a court appears to find implied consent. See *In Re Turner-Dunn* Homes, 2007 WL 3244105 (Bankr. D AZ 2007). Further, as the Fifth Circuit determined in *In re Skuna River Lumber, LLC*, 564 F.3d 353 (5th Cir. 2009) the court's authority to impose a 506 (c) charge must be exercised while the collateral is still property of the estate and that the surcharge is a charge on property, an *in rem* obligation, not an *in personam* obligation.

Although every secured creditor faces the potential of surcharge, there are tools available to avoid an ugly surprise at the end of the case. Considering the risk of surcharge, a secured creditor should avoid any risk of "impliedly consenting" to a surcharge but should, especially where the estate is selling the creditor's collateral,

consider negotiating with the estate representatives the appropriate charges before they are incurred. Where there is a potential that the estate may be administratively insolvent address directly and upfront the issue of how administrative claims will be paid. A common practice is to negotiate the surcharge issue in connection with negotiation of a "carve out" for the benefit of professionals and other administrative expenses as part of any order authorizing to use cash collateral in a Chapter 11. The negotiation of a reasonable carve out to pay for the expenses of the estate allows the secured creditor to negotiate a ceiling or at least a process that creates a ceiling on expenses as most courts will enforce a waiver of 506(c) where it has been negotiated in good faith. A properly negotiated carve out allows the secured lender to control that 506 (c) expense while monitoring the estate's efforts and should include a negotiation of a waiver or restriction on 506 (c) charges as part of consideration for the carve out. Courts, although generally requiring disclosure to approve such a waiver, will enforce such provisions if they are included in a negotiated and approved order for use of cash collateral. See for instance *In Re Compton Impressions, Ltd, supra* or *Inteli Quest Media Corp.*, 326 BR 825 (10th Cir. BAP 2005) wherein the Court denied a request to assert a 506 (c) claim where a waiver was included in the approved cash collateral order.