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Feature

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"Secured Creditor Shake[down]"

Defending Collateral Surcharge after Failed Debtor's "Gamble"

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A debtor, and its professionals will often file for chapter 11 optimistic that the debtor's actions will result in maximized recovery for all parties in interests, including the debtor's professionals. A recent opinion from the U.S. Bankruptcy Court for the Western District of Tennessee considered who shoulders the blame when the "gamble" fails.[1] In this case, the debtor attempted to surcharge the secured lender's collateral to make up for the estate's cash shortfall.

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."[2] The section allows a trustee to recover post-petition expenses associated with the preservation or disposition of estate property from either the collateral or the benefited secured creditor.[3] The allowance of expenses under § 506(c) is commonly referred to as a "surcharge of collateral," meaning that the estate receives compensation or reimbursement by a secured creditor either directly or indirectly out of proceeds of the secured creditor's collateral.[4] The provision's purpose is to prevent a windfall to a secured creditor at the expense of the estate, "as it would be unfair for unsecured creditors and the debtor's estate to have to pay the costs that benefit only a secured party and its collateral."[5] Recovery under § 506(c) is not dependent on the secured creditor's status as oversecured, and collateral may be surcharged if a secured creditor is undersecured.[6]

Surcharging collateral subject to a security interest is the exception—not the rule—for recovering costs and expenses associated with the preservation or disposition of estate property.[7] Accordingly, the party seeking a surcharge faces an "onerous" burden of proof of establishing entitlement to the payment of its claim.[8] The costs and expenses contemplated in § 506(c) are ordinarily paid from the unencumbered assets of a bankruptcy estate rather than from secured collateral.[9] Therefore, only expenses properly identified as incurred primarily for the benefit of the affected secured creditor may be charged against that secured creditor.[10]

The party seeking a surcharge may recover only to the extent of the benefit conferred on the secured creditor.[11] Where the benefit to the secured creditor is indefinite or remote, no surcharge recovery is permitted under § 506(c).[12] The creditor must receive a benefit that is direct and quantifiable rather than merely speculative.[13] To demonstrate such a benefit, the movant must show that its actions caused the secured creditor to realize over and above what it would have realized without the movant's intervention.[14]

1 *In re TIC Memphis RI 13 LLC*, No. 12-29322, at 7 (Bankr. W.D. Tenn. Jan. 10, 2013).
2 11 U.S.C. § 506(c).
3 *See* Hon. Nancy C. Dreher and Hon. Joan N. Feeney, *Bankruptcy Law Manual* § 6:50 (2011) (citing cases).
4 *See id.*
5 *Id.* (citing cases).
6 *Id.* (citing cases).
7 *See, e.g., In re Felt Mfg. Co. Inc.*, 402 B.R. 502, 510 (Bankr. D.N.H. 2009) ("Section 506(c) is an exception to this general rule where the trustee (or debtor-in-possession) expends funds to preserve or dispose of property securing the debt."); *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.") (internal citations omitted).
8 *In re Debbie Reynolds Hotel & Casino Inc.*, 255 F.3d 1061, 1068 (9th Cir. 2001).
9 *See, e.g., Ford Motor Credit Co. v. Reynolds & Reynolds Co. (In re JKJ Chevrolet Inc.)*, 26 F.3d 481, 483 (4th Cir. 1994).
10 *See, e.g., In re Cascade Hydraulics & Util. Serv.*, 815 F.2d 546, 548 (9th Cir. 1987); *In re Saybrook Mfg. Co. Inc.*, 130 B.R. 1013, 1021 (Bankr. M.D. Ga. 1991).
11 *Golden v. Chicago Title Ins. Co. (In re Choo)*, 273 B.R. 608, 612 (B.A.P. 9th Cir. 2002).
12 *Pettigrew v. Consultants United (In re SpecialCare Inc.)*, 209 B.R. 13, 19 (Bankr. N.D. Ga. 1997).
13 *TNB Fin. Inc. v. James F. Parker Interests (In re Grimland Inc.)*, 243 F.3d 228, 232-33 (5th Cir. 2001) (citing cases); *In re Flagstaff Foodservice Corp.*, 762 F.2d 10, 12 (2d Cir. 1985); *see In re Chicago Lutheran Hosp. Ass'n*, 89 B.R. 719, 728 (Bankr. N.D. Ill. 1988) (noting that secured creditor cannot be required to bear expenses that benefit estate under theory that expenses were incurred to preserve assets of the estate as whole); *see also Cascade Hydraulics*, 815 F.2d at 548 ("A debtor does not satisfy her burden of proof by suggest[ing] hypothetical benefits.").
14 *See In re Crutcher Concrete Const.*, 218 B.R. 376, 380-81 (Bankr. W.D. Ky. 1998); *In re Lambert Implement Co. Inc.*, 44 B.R. 860 (Bankr. W.D. Ky. 1984).

Defeating a Surcharge Motion

In order to prevail on a § 506(c) surcharge motion, the movant must show that the services for which it seeks compensation were necessary and reasonable, and benefited the secured creditor.[15] The U.S. Bankruptcy Court for the Western District of Tennessee recently clarified that for an action to satisfy the "necessary" prong of § 506(c), the action *must be required* to preserve or dispose of the property securing the debt. The court stated that "[w]here actions are elective and forgo other viable actions and options, such actions are not ... by nature necessary."[16] Further, a movant must also demonstrate that the actions performed are substantially similar actions to what the secured lender would have taken, had it been in possession of the subject property.[17]

In *TIC Memphis RI 13 LLC*, the debtor filed a chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware to stop a scheduled and imminent nonjudicial foreclosure sale of the debtor's sole asset, a 24.10866 percent tenant in common interest in a ground lease operated as a Residence Inn hotel in downtown Memphis, Tenn.[18] Almost immediately after the filing of the chapter 11 petition, the sole secured creditor, whose lien was attached to all of the debtor's assets and the underlying real property, moved to transfer the case venue from the District of Delaware to the Western District of Tennessee, where the real property was located.[19] The debtor and secured lender entered an agreed order transferring the case to Memphis, Tenn., giving the debtor time to try and sell the property and pay the secured lender in full under a § 363 sale motion.[20] After establishing bid procedures and holding an auction, a final sales price was obtained that left the estate insolvent, as the secured creditor was not paid in full in accordance with the stipulated agreement.[21]

Subsequently, the debtor filed a surcharge motion seeking to pay the debtor's professionals from the cash proceeds of the sale.[22] The debtor alleged that the entire bankruptcy process was necessary because it provided an opportunity to achieve the highest and best sale price for the debtor's property and allowed the various tenant-in-common interests to be bundled and sold free and clear of all encumbrances.[23] The secured creditor argued that a similar sale of the debtor's single asset could have been successfully accomplished absent the costs and process of a bankruptcy filing, as the secured lender could have simply foreclosed its interest in the property at the scheduled foreclosure sale instead of waiting for the § 363 sale to take place.[24]

While the court found the debtor's actions "somewhat" reasonable under its § 506(c) analysis, it did not find that the debtor's actions were necessary nor that they benefited the secured creditor.[25] In other words, "reasonableness in and of itself does not infer necessity, as one can have reasonable elective actions just as one can have reasonable necessary actions."[26]

> **Not only do a debtor's actions seeking surcharge need to be necessary, such actions also cannot "forgo other viable actions and options" at the secured lender's expense.**

In denying the debtor's motion, the court focused on the fact that the § 363 sale of the property served no purpose other than to provide an opportunity to obtain the highest bid possible and to dispose of the property, which could have been done "absent a chapter 11 bankruptcy case in a chapter 7 case or through a nonjudicial foreclosure sale under applicable state law."[27] While the court acknowledged that the chapter 11 process allows the debtor in possession (DIP) or trustee an exclusive period to formulate and file a plan and in effect control how the property of the estate is preserved or disposed of, according to the court the better business judgment might have been to allow the secured creditor to foreclose on the collateral.[28] In other words, the court reasoned that "[d]ebtors may use the bankruptcy system to attempt to sell a single asset; however, such use should not come at the expense of an objecting secured creditor."[29] Along the same lines, "[h]ad 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."[30]

Likewise, the court found that the debtor's actions were not necessary. While the debtor acted reasonably in electing to use the privileges afforded by chapter 11, the debtor did not act out of necessity as other means of disposing of the property were readily available to the debtor.[31] The court reasoned that if a chapter 11 case had been necessary to dispose of the debtor's single asset, the debtor's creditors could have filed an involuntary chapter 11 case or consented to the debtor's chapter 11 case, neither of which occurred.[32] According to the court, when an action is "necessary" under § 506(c), in theory, the actions pursued by the movant "should be the same actions or substantially similar actions that the secured creditor would take if it had possession of the property rather than the estate having possession."[33]

Lastly, the court found that the debtor and its professionals did not satisfy the "benefit" prong of § 506(c), noting that § 506(c) limits recovery against property securing an allowed claim "to the extent of any benefit to the holder

15 *See, e.g., SpecialCare Inc.*, 209 B.R. at 19; *Saybrook Manufacturing*, 130 B.R. at 1016. Where a secured creditor consents to the surcharge of the collateral, the trustee or debtor in possession need not show necessity, reasonableness or benefit to the secured party in order to recover the expense. *See, e.g., In re Compton Impressions Ltd.*, 217 F.3d 1256, 1260 (9th Cir. 2000).
16 *In re TIC Memphis RI 13 LLC*, No. 12-29322, at 7 (Bankr. W.D. Tenn. Jan. 10, 2013) (emphasis added).
17 *Id.* at 9.
18 *Id.* at 2.
19 *Id.* at 2-3.
20 *See id.* at 3-4.
21 *Id.*
22 *Id.*
23 *Id.* at 5.
24 *Id.* The debtor's bankruptcy case was filed on the eve of a properly noticed nonjudicial foreclosure sale.
25 *Id.* at 9-10.
26 *Id.* at 8.
27 *Id.* at 5. *See also In re Compton Impressions Ltd.*, 217 F.3d 1256 (9th Cir. 2000) (denying debtor's surcharge motion where secured creditor would have been paid in full if it had foreclosed on property at outset of chapter 11 case); *In re West Post Road Props. Corp.*, 44 B.R. 244, 246 (Bankr. S.D.N.Y. 1984) (section 506(c) surcharge denied because secured creditor would have received full amount of claim in foreclosure).
28 *In re TIC Memphis RI 13 LLC*, No. 12-29322, at 6-7 (Bankr. W.D. Tenn. Jan. 10, 2013).
29 *Id.* at 6.
30 *Id.*
31 *Id.* at 8.
32 *Id.* at 7.
33 *Id.* at 9.

of such claim."[34] If reasonable and necessary actions do not provide a benefit at the end of the action, the trustee or DIP cannot recover under § 506(c).[35] The court further noted that the benefits must be direct, not speculative, hypothetical or unascertainable.[36]

While the court acknowledged that the secured creditor did receive some benefit from the debtor's actions as the property was liquidated, the court found it questionable as to whether this benefit was the best result for the secured creditor especially in light of the significant costs and delays the secured creditor could have avoided absent the debtor's bankruptcy filing.[37] The court refused to indulge in a "hypothetical balancing act" among the § 363 sale price, a hypothetical foreclosure sales price and fees that were or would have been incurred by the secured creditor, as the court was of the opinion that such a "tenuous and speculative balancing act was not the intended purpose of a § 506(c) analysis."[38]

According to the court, § 506(c) has typically been used to surcharge the secured creditors' collateral "in situations where imminent loss was certain to result and actions were necessary to preserve or dispose of the asset to maintain the value for the secured creditor."[39] Consequently, "[w]here the secured creditor in hindsight would not seek the same or substantially similar benefit if placed in the same position of the trustee or [DIP], the court is hard pressed to find that a benefit for the secured creditor resulted."[40] In the end, the court found that the debtor and its professionals did not carry the high burden of proving that a direct, quantifiable benefit was conferred on the secured lender to warrant the proceeds of the sale being surcharged.[41]

Conclusion

The *TIC Memphis* case further illustrates the high standards placed on a movant attempting to satisfy the three-pronged requirements of § 506(c) as the court only clarifies the "necessary" and "benefit" prongs. Not only do a debtor's actions seeking surcharge need to be necessary, such actions also cannot "forgo other viable actions and options" at the secured lender's expense. This case also provides a warning to debtors' professionals as to their limited chances of recovery if a gamble regarding disposition of the collateral comes up short. abi

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34 *Id.* at 8-10.
35 *See id.* at 9-10.
36 *Id.* at 8.
37 *Id.* at 8-9.
38 *Id.* at 9.
39 *Id.*
40 *Id.*
41 *Id.* at 10.