

# **Section 506(c): What We Know and Don't Know About Charging A Secured Creditor's Collateral for the Costs of Chapter 11**

by  
**Irving E. Walker**  
**Michele E. Cosenza**  
**G. David Dean**  
**Cole, Schotz, Meisel, Forman & Leonard, P.A.**  
**Baltimore, MD and New York, NY**

## **I. Introduction**

After great expectations and anticipation among bankruptcy lawyers and other insolvency professionals, a new wave of Chapter 11 filings began to surge into our bankruptcy courts since the 2007 Views from the Bench program. These recent cases, however, frequently share an unmistakable characteristic. In large numbers, these cases have proven to be liquidating cases.<sup>1</sup> From the outset, many of the recent debtors have declared their intent, whether by choice or due to an absence of funding on any other terms, to sell all or substantially all of the debtors' assets at an accelerated pace. See, e.g., In re Fedders North America, Inc., Case No. 07-11176 (BLS) (Bankr. D. Del. 2007); In re Fortunoff Fine Jewelry and Silverware, L.L.C., Case No. 08-10353 (JMP) (Bankr. S.D.N.Y. 2008); In re Sharper Image Corp., Case No. 08-10322 (KG) (Bankr. D. Del. 2008).

In view of this phenomenon, it should prove worthwhile to consider some of the issues that arise in liquidating Chapter 11 cases. One such issue, which the authors submit will become increasingly important, is the application of Section 506(c) of the Bankruptcy Code in liquidating

---

<sup>1</sup> That so many Chapter 11 cases are "liquidating" cases is not entirely new. See, e.g., In re Applied Theory Corp., (Bankr. S.D.N.Y. Apr. 24, 2008) (Gerber, J. Case No. 02-11868 (REG)) at 11 (observing that "liquidating Chapter 11 cases, for better or worse, have been the rule and not the exception in this Court and others over the last decade, if not longer.")

cases where the secured creditors prove to be undersecured. The state of the law relating to § 506(c), and some of the issues remaining unresolved under that Section, will be the focus of the discussion that follows.

## **II. What We Know and Don't Know About Section 506(c)**

### **A. Basic Elements of a § 506(c) Claim**

In general, expenses associated with the administration of a bankruptcy estate, absent an agreement to the contrary, must be paid from assets of the estate unencumbered by any security interest or lien, and are not chargeable against a secured lender's collateral. Section 506(c) of the Bankruptcy Code provides, however, for an exception to this general principle. Under § 506(c), a trustee or debtor in possession may recover from 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); In re Visual Ind., Inc., 57 F.3d 321, 325 (3d Cir. 1995); In re C.S. Assocs., 29 F.3d 903, 906 (3d Cir. 1994); General Electric Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.), 739 F.2d 73 (2d Cir. 1984) ("Flagstaff I"). The premise underlying § 506(c) is that the unsecured creditors should not be required to bear the costs of preserving a secured creditor's collateral. In re Evanston Beauty Supply Inc., 136 B.R. 171, 175 (Bankr. N.D. Ill. 1992).

#### **1. Elements of Proof**

The starting point for determining the requirements for a valid claim under § 506(c) is the language of the statute: (i) the expense must be reasonable; (ii) it must be a necessary cost of preserving or disposing of property subject to a lien; and (iii) the claim is limited to the extent of any benefit to the secured creditor.

a. The Reasonable and Necessary Requirements.

The reasonable and necessary requirements do not appear to require much explanation. Expenses are “necessary” to the extent that the expenses, in the circumstances of a particular case, are incurred to preserve or increase the value of the secured creditor’s collateral. There may well be cases, however, in which the challenge of proving the “necessary” element is more difficult than expected. For example, in the case of In re Compton Impressions, Ltd., 217 F.3d 1256 (9th Cir. 2000), the Chapter 11 debtor moved to surcharge the secured creditor for services rendered and expenses incurred by the debtor’s law firm and sales and marketing company for assisting in completing the development and sale of units in the debtor’s residential development. Finding that the secured creditor would have been paid in full if it had foreclosed on the property at the outset of the Chapter 11 case, the court denied the motion, except for certain attorneys’ fees and costs that the court found benefited the secured creditor. Id. at 1260-61. Accord, In re West Post Road Props. Corp., 44 B.R. 244, 246 (Bankr. S.D.N.Y. 1984) (§ 506(c) surcharge denied because secured creditor would have received full amount of claim in foreclosure).

It was not enough that the unpaid administrative expenses were incurred in the disposition of the secured creditor’s collateral. Noting that, during the course of the Chapter 11 case, the secured creditor had agreed to pay for certain expenses under cash collateral stipulations with “carve-out” provisions, the court found that expenses beyond those covered by the carve-outs were incurred as part of the debtor’s attempt to salvage some equity from the project, and were not necessary for the benefit of the secured creditor. In re Compton Impressions, Ltd., 217 F.3d at 1261.

b. The Benefit Requirement.

The third requirement of § 506(c) is that the secured creditor receive a benefit from the expense for which a surcharge is requested. This has been said to be the most important element, as well as the most difficult to prove. See In re Evanston Beauty Supply, Inc., 136 B.R. at 176. Indeed, while the “benefit” concept would appear to be a simple one, its application in a particular case can prove quite vexing. Before getting to the more difficult application of the benefit requirement, some clear observations can be made from the existing case law. First, secured creditors should be happy to know that courts generally recognize that § 506(c) was not intended to cover ordinary administrative expenses attributable to the general activities of a bankruptcy case. Instead, “it was designed to extract from a particular asset the cost of preserving or disposing of that asset.” United Jersey Bank v. Miller ( In re C.S. Associates), 29 F.3d 903, 907 (3d Cir. 1994). Second, law firms should be happy to know that the unpaid fees of counsel for the debtor in possession may well qualify for a § 506(c) surcharge.

In In re Croton River Club, 162 B.R. 656 (Bankr. S.D.N.Y. 1993), the debtor owned a mixed-use real estate development, including a boat marina, which eventually ended up in Chapter 7. The debtor’s counsel moved to surcharge the sale proceeds of the secured creditor’s collateral for the firm’s unpaid fees, to the extent they exceeded the available unencumbered funds of the estate. Finding that the firm’s work preserved the debtors’ marina business as a going concern, and that certain litigation won by the firm increased the sale value of the marina, the court approved the § 506(c) claim. 162 B.R. at 659-60. Quoting the Eighth Circuit Court of Appeals in U.S. v. Boatmen’s First Nat’l Bank, 5 F.3d 1157, 1159-60 (8th Cir. 1993), overruled on other grounds, 150 F.3d 868 (8th Cir. 1998) (en banc), aff’d, 530 U.S. 1, 120 (2000) (“Boatmen’s”), the court noted that “the ambition of [a] creditor to preserve and improve its

secured collateral and the opportunity to realize that ambition’ is indeed a ‘benefit’ which will support the award of § 506(c) expenses.” *Id.* at 660.

Similar broad statements are invoked in other cases. *See, e.g., In re Trim-X, Inc.*, 695 F.2d 296 (7th Cir. 1982) (“*Any time* the trustee or debtor in possession expends money to provide for the reasonable and necessary cost and expense of preserving ... a secured creditor’s collateral, the trustee or debtor in possession is entitled to recover such expense from the secured party . . . .”) (citing 124 Cong. Rec. H11089 (Sept. 28, 1978), *reprinted in* 1978 U.S. Code Cong. & Ad. News 6436, 6451).

Other courts apply a more stringent standard in considering whether an administrative expense benefited the secured creditor sufficiently to allow a § 506(c) surcharge. In *Flagstaff I* and *General Electric Credit Corp. v. Peltz (In re Flagstaff Foodservice Corp.)*, 762 F.2d 10, 12 C.B.C.2d 1019 (1985) (“*Flagstaff II*”), the Second Circuit reversed the bankruptcy court’s decisions allowing (i) professionals for the debtor and creditors’ committee to be paid their allowed compensation (in *Flagstaff I*), and (ii) unpaid payroll taxes (in *Flagstaff II*), from the secured creditor’s collateral. In *Flagstaff*, the attempt to reorganize failed, no Chapter 11 plan was filed, and there was no sale of the business as a going concern. The Second Circuit found no benefit to the secured creditor from the professionals’ services or the payroll taxes, and rejected the argument that the secured creditor “impliedly consented.” 739 F.2d at 75. According to the Second Circuit, “such consent is not to be lightly inferred.” *Id.* The court further noted that if mere cooperation with the debtor exposed a secured creditor to payment of administrative expenses of a Chapter 11 case, it would “make it difficult, if not impossible, to induce new lenders to finance a Chapter 11 operation.” *Id.*

Flagstaff II further emphasized what is required to meet the “benefit” element, stating that the debtor in possession must show that the expense was incurred “primarily” for the benefit of the secured creditor, and that the creditor “directly” benefited from it. 762 F.2d at 12. Accord, In re C.S. Assocs., 29 F.3d at 906 (requiring a showing of direct benefit to secured creditor).

## 2. What We Don’t Know About the “Benefit” Element

The preceding quotes from the Eighth and Seventh Circuits and legislative history raise as many questions as they may seem to answer. For example, taken literally, these broad statements would appear to support the argument that in any case where the secured creditor cooperates with the debtor in the hope of preserving and improving the realizable value of its collateral, such cooperation would leave the secured creditor vulnerable to § 506(c) claims. And what about a Chapter 11 liquidating case in which the primary focus is the sale of the debtor’s business? The major constituents may have begun the case hopeful of generating sufficient sale proceeds to provide a recovery for unsecured creditors, but it turns out that these hopes are dashed and the secured creditors are not fully paid from the sale proceeds. In such cases, under the broad statements quoted in the prior section, there would appear to be a good argument for successful § 506(c) claims.

This appears to be a winning argument in the Eight Circuit. In In re Machinery, Inc., 287 B.R. 755 (Bankr. E.D. Mo. 2002), the bankruptcy court permitted the debtor to surcharge the collateral of a secured creditor with a lien on equipment that the debtor leased to third parties as part of its business. The court allowed the debtor’s § 506(c) claim in the amount the debtor spent in continuing to operate its business during the pendency of the case. 287 B.R. at 760. The court followed the Eight Circuit’s opinion in Boatmen’s, which states that a secured creditor who

“consents” to the debtor’s continued operation of business must bear the cost of the administrative expenses the debtor incurs in operating the business. 5 F.3d at 1160.

The Eighth Circuit’s reasoning may be seen by many as troubling. The Eighth Circuit’s approach may well have the undesirable effect of discouraging a secured creditor from cooperating with the Chapter 11 debtor, and may thus foster hostilities -- contrary to the public policy embodied in bankruptcy law and practice that encourages cooperation and consensual relations among parties with disparate interests.

It is thus not surprising that most courts do not go as liberal as the Eighth Circuit in finding a secured creditor’s consent or benefit to the secured creditor. In denying the § 506(c) claim asserted by the debtor’s attorney in Evanston Beauty Supply, Inc., the court spoke of the “benefit” requirement in this way:

The key element for recovery under section 506(c) is whether the services conferred a direct benefit on the Bank. The secured creditor cannot be required to bear expenses which benefit the estate under the theory that the expenses were incurred to preserve the assets of the estate as a whole. Chicago Lutheran, 89 B.R. at 728. Section 506(c) does not convert ordinary administrative expenses to preservation costs through a broad definition of benefit. In re C.I.T. Corp. v. A & A Printing, Inc., 70 B.R. 878, 881 (Bankr.M.D.N.C. 1987). The Applicant has not shown that the continued operation in Chapter 11 and the resultant sale produced any higher or enhanced realized value to the Bank of the liquidated assets, or conversely that the Applicant’s services in any way diminished any loss of realized asset value to the Bank. Although part of the Applicant’s work undoubtedly conferred a qualitative and general benefit to the Bank, the requisite showing of a precise quantitative benefit has not been proved. Dozoryst, 21 B.R. at 394.

136 B.R. at 177.

The existing case law does not permit confidence in attempting to predict how courts will apply broad statements of principle to a liquidating Chapter 11 involving the sale of the debtor’s business. Sure the investment banker who arranges the sale deserves to be paid, as does the

debtor's lawyer for fees incurred in connection with a sale under Section 363 of the Bankruptcy Code. But what about all the other work required just to enable a Chapter 11 debtor to fulfill its duties as a debtor in possession? Arguably, without the benefit of being in Chapter 11, the results of the sale process would be far worse. That argument, however, would seem to fall short of meeting the requirement of a "direct" benefit that a number of courts seem to require to qualify for the § 506(c) surcharge.

### 3. Relevance of Consent to the Section 506(c) Analysis

Expenses may also be recoverable from the secured lender's collateral if the secured creditor either consents, expressly or impliedly, to the expense, or causes it. Mere cooperation or acquiescence should not translate into consent, and "without express consent, consent will not be easily inferred." General Electric Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.), 739 F.2d at 77; In re Compton Impressions Ltd., 217 F.3d 1256, 1261 (9th Cir. 2000) (bank's joinder in cash collateral stipulation and its agreement to put off foreclosure proceedings did not constitute consent); In re Sports Information Data Base Inc., 64 B.R. 824, 827 (Bankr. S.D.N.Y. 1986) (acquiescence to auction of collateral did not constitute consent); In re Evanston Beauty Supply, Inc. 136 B.R. 171, 177 (Bankr. N.D. Ill. 1992) (noting that "implied consent is rare in the absence of express consent because a secured creditor's cooperation in reorganization or sale efforts is not the equivalent of consent to finance the costs of a reorganization case"). Compare U.S. v. Boatmen's, 5 F.3d at 1160 (holding that secured creditor consented to a § 506(c) surcharge by agreeing to continued operation of business for purpose of increasing ultimate gain), with Flagstaff, 739 F.2d at 12 (holding that secured creditor did not impliedly consent to surcharge by employing sale procedures).

The Eighth Circuit appears to be much more inclined to find implied consent than the other courts. In the Eighth Circuit, secured creditors can find themselves at risk of surcharge if

they do not expressly confirm their position either to refuse to pay expenses, or to pay only limited and specifically delineated expenses. See In re Machinery Inc., 287 B.R. 755 (Bankr. E.D. Mo. 2002) (if creditor consents to ongoing operation of business, it impliedly consents to pay for those costs; consent to use cash collateral amounts to consent to surcharge); In re Croton River Club, 162 B.R. 656, at 660 (court found implied consent based on creditor's consent to use of cash collateral stipulation).

Two recent cases addressed the issue of a secured creditor's consent to a § 506(c) surcharge. In Borrego Springs Bank, N.A. v. Skuna River Lumber, LLC, 381 B.R. 211 (N.D. Miss. 2008), one of the debtor's secured creditors filed and withdrew two motions for relief from the automatic stay to foreclose on its collateral, which included real and personal property, and agreed to a sale of the property through a bankruptcy auction, in which the secured creditor credit bid and became the purchaser. The entity that was engaged to assist in the sale filed an action asserting a right to a § 506(c) surcharge, for fees and expenses incurred through the sale efforts. The § 506(c) applicant argued that the secured creditor implicitly consented to the surcharge because the secured creditor withdrew its motion for relief from stay, consented to the sale, and participated in the subsequent auction. Although the court approved the § 506(c) surcharge, it held that the secured creditor's actions did not constitute a consent to the applicant's surcharge, especially because the secured creditor's right to challenge any surcharge request was preserved in the applicant's retention order. 381 B.R. at 215.

In In re Turner-Dunn Homes, Inc., 2007 WL 3244105 (Bankr. D. Ariz. Nov. 1, 2007), the bankruptcy court appointed a Chapter 11 trustee, pursuant to a motion filed by certain secured creditors. The trustee was successful in obtaining a favorable sale of the debtor's real estate. In authorizing the surcharge against the secured creditors, the court held that there was no credible

evidence that a benefit was not obtained from the trustee's efforts. In analyzing the benefits element, the court relied heavily on the fact that the secured creditors were the ones that moved for the appointment of the trustee and that the trustee's efforts led to the payoff of the senior secured creditor and a recovery for the junior secured party. While some courts speak in terms that seem to equate consent to a *per se* allowance of a § 506(c) surcharge, without analyzing the elements of the statute, the court in Turner-Dunn found that the implied consent of the secured creditors supported the court's conclusion that a benefit was received. Id. at 2.

#### 4. Standing to Assert a Section 506(c) Claim

Over the years, courts disagreed as to whether the creditor seeking payment under § 506(c) had standing to seek this relief, or whether such relief can be sought only by the trustee or debtor in possession. This standing issue was finally resolved by the Supreme Court in Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A., 530 U.S. 1, 7, 14 (2000), which held that the trustee or debtor in possession is the only party entitled to seek a surcharge of a secured creditor's collateral. under Section 506(c).

Hartford Underwriters does not answer all issues relating to standing. The Supreme Court expressly left open the issues of whether, in a case where the debtor fails to assert claims under Section 506(c), a creditors' committee may do so as an alternative representative of the estate, similar to the practice by which creditors' committees have been granted derivative rights to assert claims of the bankruptcy estate. 530 U.S. at 13 n.5. Another open issue is whether the unpaid administrative creditor may move to compel a trustee or debtor in possession to assert a § 506(c) claim on the creditor's behalf, and if so, the standard by which such relief may be granted.

B. Beyond the Basics

1. What We Know about Waiver of Rights to Assert Section 506(c) Claims

In preparing to commence a Chapter 11 case, debtors generally look to their prepetition lender to provide postpetition financing, especially when the prepetition lender already has a blanket lien on the debtors' assets. In such cases, the existing secured lender has incentive to provide postpetition financing to protect the value of its collateral.

However, the lender may require, as a condition to providing such financing, a waiver of the debtor's right to surcharge its collateral under § 506(c). The lender's argument for this requirement is that without it, the lender would need to impose more restrictive postpetition lending terms, to take into account the risk of being subjected to unquantifiable claims to impose on the lender a substantial portion of the costs of administration of the Chapter 11 case. A Section 506(c) waiver requirement by a postpetition lender has become quite common.

In cases where a § 506(c) waiver has been approved as part of debtor in possession financing or use of cash collateral, courts generally have denied subsequent attempts to assert a § 506(c) claim, on the grounds of *res judicata*. See InteliQuest Media Corp. v. Miller (In re InteliQuest Media Corp.), 326 B.R. 825, 831 (10th Cir. BAP 2005) (§ 506(c) claim asserted by former counsel for debtor in possession for unpaid legal fees barred by *res judicata*, where prior court orders approved waiver of § 506(c) rights); In re Molton Metal Technology, Inc., 244 B.R. 515, 525 (Bankr. D. Mass. 2000) (former employees § 506(c) claims for severance payments, which the Chapter 11 debtors agreed to pay under postpetition employee retention agreements, denied based upon *res judicata*, rejecting argument that a § 506(c) waiver violates public policy); Weinstein, Eisen & Weiss v. Gill (In re Cooper Commons LLC), 512 F.3d 533, 535,36 (9th Cir. 2008) (§ 506(c) claim by debtor's former counsel, who represented the debtor in negotiating postpetition financing agreement including the waiver, denied based on *res judicata*).

Getting a § 506(c) waiver approved, however, is far from a sure thing, and depends on the court being asked. First, the form of the waiver may overreach. One example of a § 506(c) waiver held to be unenforceable is In re Ridgeline Structures Inc., 154 B.R. 831 (Bankr. D.N.H. 1993). In that case, the debtor entered into a stipulation with its secured creditor, including a § 506(c) waiver "no matter what action, inaction, or acquiescence by [the secured party] might occur". Id. at 832. The court ruled that this particular form of waiver was against public policy and unenforceable *per se*, warning "it is not authorized to and never would insulate any party from the consequences of their conduct no matter how egregious". Id. It is worthy of note that the court refused to approve the waiver, in part, due to allegations of egregious conduct on the part of the secured creditor.

At least two other courts have denied approval of a § 506(c) waiver in a proposed cash collateral order. In re Willingham Invs., Inc., 203 B.R. 75, 80 (Bankr. M.D. Tenn. 1996) (holding that secured creditor could not immunize its prepetition claims from a surcharge under § 506(c) in cash collateral order by receiving superpriority claim under § 507(b)); McAlpine v. Comercia Bank-Detroit (In re Brown Bros., Inc.), 136 B.R. 470, 474 (W.D. Mich. 1991) (holding that § 506(c) waiver was not enforceable as a matter of law "in light of the congressional mandate that a trustee have the authority to use a portion of secured collateral for its preservation or proper disposal."). The McAlpine case adopted a *per se* rule prohibiting the proposed § 506(c) waiver.

## 2. What We Don't Know about § 506(c) Waivers.

A more interesting question is whether a bankruptcy court should approve a § 506(c) waiver as part of a postpetition financing or use of cash collateral agreement. The courts are

rightly concerned that bankruptcy, being an “intensely practical affair”<sup>2</sup>, must consider the impact of not approving such waivers on the ability of Chapter 11 debtors to obtain necessary postpetition funding. Courts also should recognize, however, that at the outset of a Chapter 11 case, it is often difficult to predict the ultimate outcome of the case, and which party may be adversely affected by a blanket § 506(c) waiver. Another question for which there is little guidance is what standard the court should follow in determining whether to sustain or overrule an objection by a creditors’ committee or other party objects to a proposed § 506(c) waiver provision in a postpetition financing order.

### **III. Closing Observations**

The existing case law leaves wide open for argument how courts should apply § 506(c) in a Chapter 11 liquidating case where there is no § 506(c) waiver and some estate assets not encumbered by any liens. In such a case, particularly where the secured creditor is undersecured and much of the case is focused on sale of the debtor’s business, the debtor’s rights to assert § 506(c) claims may become an important issue in contested confirmation proceedings. Through § 506(c), the debtor and its unsecured creditors may seek to allocate to the secured creditor a substantial portion of the costs of the Chapter 11 case. Even after 30 years of case law under the Bankruptcy Code, there is little guidance with respect to the issue of how much of the expenses of Chapter 11 should be borne by a secured creditor in the circumstances of a particular liquidating case. The deciding factor when this issue is argued will be how courts apply the “benefit” requirement of § 506(c). With the latest wave of large Chapter 11 liquidating cases, perhaps we soon will have the benefit of answers to this important issue.

---

<sup>2</sup> Weinstein, Eisen & Weiss v. Gill, (In re Cooper Commons, LLC), 512 F.3d at 534.