

**No Surcharge for You: Third Circuit Rules
That Section 506(c) Surcharge Is "Sharply Limited"**

January/February 2014

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The ability to "surcharge" a secured creditor's collateral in bankruptcy is an important resource available to a bankruptcy trustee or chapter 11 debtor in possession ("DIP"), particularly in cases where there is little or no equity in the estate to pay administrative costs, such as the fees and expenses of estate-retained professionals. However, as demonstrated by a ruling handed down by the Third Circuit Court of Appeals, the circumstances under which collateral may be surcharged are narrow. In *In re Towne, Inc.*, 2013 BL 232068 (3d Cir. Aug. 29, 2013), the court of appeals affirmed an order denying a motion by special counsel to direct payment of its fees and expenses by surcharging the proceeds of a secured creditor's collateral because the law firm's services did not directly benefit—and in some cases sought to disadvantage—the secured creditor.

Surcharge of Collateral

Section 506(c) of the Bankruptcy Code provides an exception to the general rule that the payment of expenses associated with administering a bankruptcy estate, including the administration of assets pledged as collateral, must derive from unencumbered assets. Under section 506(c), a trustee or DIP "may recover from property securing an allowed 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." The purpose of the provision is to prevent secured creditors from obtaining a financial windfall at the expense of the estate and unsecured creditors by ensuring that the secured creditors are responsible for the same collateral disposition costs within a bankruptcy case that normally would arise in a foreclosure or similar state law

proceeding outside bankruptcy. *See Loudoun Leasing Development Co. v. Ford Motor Credit Co. (In re K & L Lakeland, Inc.)*, 128 F.3d 203 (4th Cir. 1997); *In re TIC Memphis RI 13, LLC*, 498 B.R. 831 (Bankr. W.D. Tenn. 2013).

Three elements must be satisfied in order to surcharge collateral under the terms of section 506(c): (i) the expenditure must be necessary; (ii) the amounts expended must be reasonable; and (iii) the secured creditor must benefit from the expense. The inquiry into what costs are reasonable and necessary, and the extent to which they benefit the party being surcharged, is factual, and the party seeking recovery has the burden of establishing those elements. *See* 4 COLLIER ON BANKRUPTCY ¶ 506.05[9] (16th ed. 2014). If an expense satisfies the requirements of section 506(c), the proceeds from the sale or other disposition of the collateral must be used first to pay the surcharged expense, with any excess applied to payment of the claim(s) secured by the property. In *Towne*, the Third Circuit considered whether the sale proceeds of collateral in a chapter 7 case could be surcharged to pay the fees and expenses of special counsel retained by the DIP before the case was converted from chapter 11 to chapter 7.

Towne

Towne, Inc., and its affiliate, DMD Towne, LLC (collectively, the "Debtors"), owned and operated a franchised BMW car dealership in Oyster Bay, New York. The Debtors' assets, which consisted of the franchise agreement, the real property on which the dealership was located, and various inventory, were fully encumbered by liens securing approximately \$9 million owed to BMW Financial Services, NA, LLC ("BMW").

The Debtors filed for chapter 11 protection in New Jersey in April 2009. The bankruptcy court later authorized the Debtors to retain The Margolis Law Firm ("Margolis") as special counsel for the purpose of finding prospective purchasers.

Shortly after the petition date, BMW sought relief from the automatic stay to foreclose on its collateral. In opposing the motion, Margolis represented that it had received an offer to purchase the Debtors' assets for \$6 million. The bankruptcy court granted relief from the stay, but BMW agreed to forbear from foreclosing immediately to allow the Debtors to pursue the proposed sale transaction.

On the Debtors' behalf, Margolis commenced litigation against BMW, seeking, among other things, to reduce the amount of BMW's secured claim to \$6 million, which relief would have allowed the proposed \$6 million sale of the assets to proceed free and clear of BMW's liens under section 363(f)(3) of the Bankruptcy Code. Margolis also conducted an investigation that led to the commencement of a state court administrative proceeding against BMW regarding its lending and franchise relationship with the Debtors.

Due to the ongoing litigation, BMW, which could have blocked the proposed sale because it was significantly undersecured, refused to consent to the transaction unless the Debtors, as a quid pro quo, released BMW from the claims that had been asserted against it. The Debtors refused to do so, and the sale fell through.

In August 2009, the bankruptcy court converted the Debtors' cases to chapter 7 and appointed a trustee to liquidate the estate. Shortly afterward, BMW contacted prospective purchasers of the Debtors' assets, and the trustee and BMW selected a buyer willing to pay \$5.5 million from several bidders. As part of the proposed transaction, the trustee agreed to execute releases in favor of BMW on behalf of the estate. The bankruptcy court approved the sale in early 2010. The court's order included a consensual carve-out from the sale proceeds in the amount of \$177,000 for the benefit of the trustee, as well as a 10 percent distribution to general unsecured creditors.

Margolis subsequently filed a motion under section 506(c) seeking payment from the sale proceeds of approximately \$90,000 in fees and expenses for services provided as special counsel to the Debtors prior to conversion of the cases. The bankruptcy court denied the request, concluding that Margolis's services benefited primarily the Debtors and their principals and that any benefit to BMW was "purely incidental and thus outside the scope of section 506(c)." The district court affirmed on appeal.

The Third Circuit's Ruling

Margolis fared no better with the Third Circuit. In its unpublished ruling, the court of appeals acknowledged its prior decisions holding that, ordinarily, an attorney's fees and expenses "may be charged only against the surplus of the debtor's estate." Section 506(c), the Third Circuit explained, "provides a limited exception to this rule" that permits a claimant to recover expenses from secured collateral "only under 'sharply limited' circumstances" (quoting *In re Visual Indus., Inc.*, 57 F.3d 321, 325 (3d Cir. 1995)).

The Third Circuit concluded that Margolis failed to meet the requirements of section 506(c) because it did not prove that its legal services and related expenses were necessary to preserve or dispose of the collateral or that such services provided a direct benefit to BMW. Although Margolis detailed its efforts to market the Debtors' assets to potential purchasers and to consummate purchase agreements for the sale of the collateral, the Third Circuit explained, such "efforts did not result in an actual sale."

Moreover, the court added, Margolis was not responsible for, or involved in any way in, the sale transaction that was later consummated. The Third Circuit agreed with the bankruptcy court's "purely speculative" characterization of Margolis's contention that it "prevented termination of the Franchise" and thereby benefited BMW by preserving the value of the collateral. In fact, the court of appeals emphasized, Margolis's legal services benefited primarily the Debtors rather than BMW and were "actually contrary to [BMW's] interests" in many respects.

The Third Circuit rejected Margolis's remaining arguments, including the contention that BMW consented to a surcharge of its collateral to pay the law firm's fees and expenses. According to the court, Margolis demonstrated nothing more than BMW's "limited cooperation with [Margolis's] initial efforts to effectuate a sale of the Collateral," which would not support a finding that BMW consented to be surcharged for Margolis's fees and expenses.

Outlook

Towne reinforces the Third Circuit's prior decisions that surcharging collateral under section 506(c) is possible only under "sharply limited" circumstances. Unless a secured creditor explicitly consents to a carve-out, a trustee or DIP attempting to surcharge collateral must be

prepared to demonstrate that the costs of preserving or disposing of collateral are necessary and reasonable and provide a direct benefit to the secured creditor.