ALERTS

# Fifth Circuit Affirms Secured Lender Surcharge

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A secured lender had to "pay the [encumbered] Property's maintenance expenses incurred while the [bankruptcy] trustee was trying to sell the Property," held the U.S. Court of Appeals for the Fifth Circuit on Dec. 29, 2015. *In re Domistyle, Inc.*, 2015 WL 9487732, at *1 (5th Cir. Dec. 29, 2015). Affirming the bankruptcy court's surcharging the lender's collateral, the Fifth Circuit acknowledged the "general rule ... that administrative expenses cannot be satisfied out of collateral Property 'but must be borne out of the unencumbered assets of the estate.'" *Id.* at *2, quoting 4 Collier, *Bankruptcy* ¶ 506.05, at 506-117 (16th ed. 2015). According to the court, though, Bankruptcy Code ("Code") Section 506(c) provides a "narrow" and "extraordinary" exception to the general rule, an exception intended by Congress "to prevent a windfall to a secured creditor at the expense of the estate." *Id.*, quoting *In re JKJ Chevrolet, Inc.*, 26 F.3d 481, 483 (4th Cir. 1994).

## Relevance

Code Section 506(c) enables the "trustee [to] recover from" collateral "the reasonable, necessary costs and expenses of preserving, or disposing of, [the collateral] to the extent of any benefit to the" secured lender. "To recover expenses under this provision, the trustee bears the burden of proving" that: "(1) the expenditure was necessary, (2) the amounts expended were reasonable, and (3) the creditor benefited from the expenses." *Id.*, quoting *In re Delta Towers, Ltd.*, 924 F.2d 74, 76 (5th Cir. 1991). *See generally In re Flagstaff Foodservice Corp.*, 739 F.2d 73, 76 (2d Cir. 1984) (if trustee incurs "properly identified" preservation expenses

"primarily for the benefit of" the secured lender, Code Section 506(c) provides an exception if the lender has either "caused" or consented to the accrual of these expenses); *In re Flagstaff Foodservice Corp.*, 762 F.2d 10, 12 (2d Cir. 1984). Other courts have explained that Code Section 506(c) essentially requires a "quantifiable and direct benefit to the secured creditor; indirect or speculative benefits may not be surcharged, nor may expenses that benefit the debtor or other creditors." *In re Blackwood Assocs. L.P.*, 153 F.3d 61, 68 (2d Cir. 1998); *In re Grimland, Inc.*, 243 F.3d 228, 232 (5th Cir. 2001).

These judicially imposed legal hurdles to a secured lender surcharge are meaningful. According to one appellate court, this is "not an easy standard to meet"; because of the "onerous burden of proof, it is unlikely that creditors will use [Section 506(c)] when any other provision of the Code is available." *In re Debbie Reynolds Hotel & Casino, Inc.*, 255 F.3d 1061, 1067-68 (9th Cir. 2001).

## Facts

The debtor ("D") in *Domistyle* owned a factory on several acres of land in Texas (the "Property"). At the outset of the bankruptcy case, all parties believed the Property to be worth more than its three outstanding mortgages, the largest of which was held by a secured lender ("S"). During the bankruptcy, the trustee "spent the better part of a year attempting to sell the Property and realize the supposed equity for the estate." *Id.* at *1-2. When the trustee's efforts failed, "dispelling any notion that there was equity in the Property, the trustee abandoned the Property to [S]." *Id.*

The bankruptcy court in the meantime had confirmed a plan of liquidation, establishing a liquidating trust that had until May 1, 2014 to sell the Property at a price "sufficiently high to cover the value of the mortgage loan owed to [S]." *Id.* at *1. Until the Property was sold, the trust was required by the liquidation plan to "maintain reasonable insurance" and "own the Real Property as a reasonably prudent owner would own it." The trustee used a commercial real estate firm to market the Property, paying the following expenses to maintain the Property: "Security, repairs to the roof and electrical system, mowing, landscaping, utilities, and insurance premiums." Despite the trustee's request to S for reimbursement of "the ongoing preservation and maintenance expenses, [S] … [objected and] rejected a proposed sale of the Property for $4 million." *Id.*

The May 1, 2014 deadline arrived, but "[S] declined to exercise either of the options given it by the plan — foreclosure or a deed-in-lieu of foreclosure." After failing to interest a potential buyer in the Property, the trustee told S "that he intended to cease paying certain expenses including 'insurance, security and utility service.'" *Id.* at *2. S objected to the trustee's refusal to pay these maintenance expenses, arguing that the trustee's "action would virtually destroy any value remaining in the … Property." *Id.*

The trustee then moved to abandon the Property as "burdensome and of inconsequential value to the Liquidating Trust." While his motion to abandon was pending, the trustee moved to "surcharge the expenses paid in maintaining the Property from the start of the bankruptcy case," a right "explicitly reserved" to him by the plan of liquidation. *Id.* When S objected to the requested surcharge, the bankruptcy court held an evidentiary hearing, during which the parties agreed that the trustee would abandon the Property as of Sept. 13, 2014, and S would reimburse the trustee for preservation and maintenance expenses as of June 1, 2014, shortly after the trustee had stated his intention to abandon the Property. Nevertheless, the parties disputed whether S could be surcharged for expenses incurred prior to June 1, 2014. The bankruptcy court later granted the trustee's request to surcharges for those expenses. S appealed, on consent, directly to the Fifth Circuit.

# Analysis

## Benefit to S

The Fifth Circuit affirmed the bankruptcy court's rejection of S's argument that it had not benefited from the expenses paid by the trustee to preserve the Property. First, the trustee admittedly maintained the Property "with the intent of benefiting [S] and the estate: He kept the Property in good shape to further his goal of selling it at a price above the amount of [S's] lien with the difference going to junior and unsecured creditors." *Id.* at *3. Although prior case law had required the asserted expenses to be incurred "primarily for the benefit of the secured creditor," the Fifth Circuit stressed that Code Section 506(c) does not contain such language, but merely "limits the amount of surcharge to 'the extent of any benefit to the' secured creditor." In other words, "Section 506(c) … [contains no] express requirement that the money be spent with any particular beneficiary in mind." *Id.*

Courts have "emphasized the unfairness of requiring 'the general estate and unsecured creditors … to bear the cost of protecting what is not theirs, … an inequity that can be avoided by surcharge." *Id.* at *4, citing *In re Senior-G&A, Op. Co., Inc.*, 957 F.2d 1290, 1298 (5th Cir. 1992); *In re Codesco, Inc.*, 18 B.R. 225, 229-30 (Bankr. S.D.N.Y. 1982) (surcharge denied; legal services of debtor's counsel could not be imposed on secured lender; reorganization legal services "primarily of benefit to the debtor" and any "tertiary benefit bestowed upon the secured Property … is too indefinite and remote" to support surcharge"). *See* 4 Collier, *Bankruptcy* ¶ 506.05[6][c], at 506-125 (characterizing the trend in case law to "requir[e] that [an] expenditure … be designed primarily to bestow a benefit on the secured creditor" as a way of "stat[ing] [the] concept" that "care should be taken to distinguish expenses that truly contribute to the preservation or enhancement of the secured creditor's position" from "those that have no such effect"). *See alsoIn re Cascade Hydraulics and Utility Service, Inc.*, 815 F.2d 546, 547 (9th Cir. 1987) (denied surcharge for telephone expenses, withholding taxes, social security taxes, legal fees and executive compensation from operation of debtor's business prior to liquidation); *In re Towne, Inc.*, 536 Fed. App'x 265, 269 (3d Cir. 2013) (affirming bankruptcy court's finding that "the primary benefit of [the attorney's] legal services was to the Debtors … rather than to preservation of the collateral of [the secured creditor]").

The Fifth Circuit agreed with "other circuits … that an expense which was not incurred primarily to preserve or dispose of encumbered Property cannot meet the requirement of being incurred primarily for the benefit of the secured creditor." 2015 WL 9487732, at *5. Nevertheless, "an expense incurred primarily to preserve or dispose of encumbered Property [does meet] the requirement." In *Domistyle*, the "necessary direct relationship between the expenses and the collateral is obvious … ; all of the surcharged expenses related only to preserving the value of the Property and preparing it for sale." *Id.* In *Senior-G&A*, 957 F.2d at 1300, the court had previously "rejected the creditor's argument that *primarily* means *solely* with a common-sense explanation: The 'very fact that [the secured lender] received 59.5% of the production rendered the work-over expenses 'primarily' for its benefit.'" *Id.* at *6. In *Domistyle*, S's "lien represented almost two-thirds of the collateral's [perceived] value," and the mere "possibility … that [the expenses] could also benefit other creditors does not render surcharge unavailable." *Id.*

## Pre-Abandonment Expenses

The court of appeals also rejected S's argument that it could not be surcharged for expenses incurred before the trustee determined that the Property had no equity. The court saw "a number of problems with a rule foreclosing the possibility of Section 506(c) surcharge for any expenses incurred prior to attempted abandonment. First, it is inconsistent with our earlier pronouncement that the 'Section 506(c) analysis is particularly case specific.'" *Id.*, quoting *Senior-G&A*, 957 F.2d at 1300. S's position, reasoned the court, could "result in the unjust enrichment that the statute aims to prevent … . Such would be the case here if [S] were to avoid the surcharge, given that there is no indication it could have sold the Property earlier and avoided these expenses." *Id.*

S's position would also "limit Section 506(c) to expenses incurred during the usually brief window of time when the trustee has attempted to abandon but has not been authorized to abandon." Because of all these concerns, the court saw "no basis for adopting a rule that is largely unmoored from the statutory text." *Id.* Nevertheless, Code Section 506(c) provides the trustee with "an incentive to act promptly in determining whether an asset has equity for the estate." *Id.* at *7. The precise language of the statute "limits the trustee's recovery to 'necessary' preservation and disposal costs and expenses." If a trustee were to delay in realizing an asset's value "and the value turns out to be less than the creditor's secured interest, the creditor can challenge the necessity of the costs incurred by the trustee." *Id.*

## Quantification of Benefit

Finally, the court rejected S's argument that the trustee had failed to quantify the benefit it had received. In the court's view, it was "obvious that [S] obtained some benefit from the expenses. Consider the security, lawn mowing and roof repairs paid for by [the trustee], to name just a few of the expenses surcharged." *Id.* Had the trustee not incurred these expenses, [S] would "have been left trying to sell a vacant building damaged by vandalism, filled with overgrown weeds, and saddled with a leaking roof." *Id.*

The bankruptcy court, in the view of the Fifth Circuit, properly found that S "received a direct and quantifiable benefit from [the trustee's] stewardship of the Property." *Id.* The trustee's "real estate broker testified 'that the value preserved was at least as much as the amount expended.'" *Id.* Because S ineffectively cross-examined the witness and failed to offer a different valuation, the benefit to S found by the lower court "was, at

minimum, equal to the amount of the expenses paid." *Id.* In short, reasoned the court, "[S's] articulated rule … would preclude surcharge of pre-abandonment expenses" and stretch "Section 506(c) beyond its text and contradict … its equitable purpose." *Id.* at *8.

## Comment

*Domistyle* confirms the practical difficulty that a trustee ordinarily has in surcharging a secured lender for the expense of preserving its collateral. Nevertheless, the case not only explains the applicable requirements, but also shows that a trustee's strong factual showing can support a surcharge. In the end, courts will ask whether the secured lender would benefit from actions taken to preserve its collateral without bearing the cost. *See* 4 Collier, *Bankruptcy* ¶ 506.05, at 506-116.

*Authored by Michael L. Cook.*

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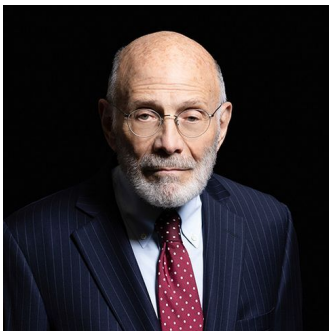

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