Lenders and Other Secured Good News for DIPs

Section 506(c) Waiver Enforceable: Good News for DIPs and Other Secured Lenders

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As a general proposition, the administrative expenses that a debtor-in-possession (DIP) or trustee pays or incurs in a bankruptcy case are payable only from the unencumbered assets of the debtor’s estate and are not chargeable to a secured creditor or its collateral. However, §506(c) of the Bankruptcy Code is an exception to this rule. Section 506(c) states as follows:

The trustee 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.

The statute is intended to require a secured creditor’s payment of all costs paid or incurred by a debtor or trustee to benefit the creditor by protecting, or facilitating the disposition of, the creditor’s collateral. A secured creditor should not be permitted to recover a windfall, at the expense of the secured creditor should not be permitted to recover a windfall, at the expense of the secured creditor’s payment of all costs paid or incurred by a debtor or trustee to benefit the creditor by protecting, or facilitating the disposition of, the creditor’s collateral for payment of certain paid or unpaid administrative expense claims that purportedly benefited that secured lender and/or its collateral, despite the §506(c) waiver contained in a previously court-approved financing or cash collateral order.

In a recent decision, the U.S. Bankruptcy Appellate Panel (BAP) for the Tenth Circuit, in InteliQuest Media Corp. v. Miller (In re InteliQuest Media Corp.), 326 B.R. 825 (10th Cir. BAP (Utah) 2005), upheld the denial of the debtors’ §506(c) surcharge claim against its secured lender based on the doctrine of res judicata, where a previously court-approved financing order and subsequent court orders contained waivers of §506(c) surcharge claims against the lender and its collateral. This decision should provide comfort to lenders that the rights and protections they negotiate with a trustee or DIP in a court-approved financing or use of cash-collateral arrangement will not be subsequently undone.

Facts of InteliQuest Media Corp.

The debtors (InteliQuest) entered into a chapter 11 financing stipulation with one of their lenders, Zions First National Bank. This stipulation contained the debtors’ waiver of §506(c) surcharge claims against Zions. The bankruptcy court entered a preliminary, and then a final, order approving the stipulation. Neither order was subject to an appeal.

Thereafter, the bankruptcy court ordered the appointment of a chapter 11 trustee, who displaced the debtors’ management, and then continued as trustee following the conversion of the debtors’ case to chapter 7. Zions needed the trustee’s assistance to liquidate its collateral. The trustee was not willing to work on a gratis basis and negotiated relief from the surcharge waiver contained in the earlier financing order. The trustee and Zions entered into a stipulation that authorized the trustee to surcharge Zions’s collateral for the trustee’s expenses incurred in disposing of Zions’s collateral, and reserved the trustee’s right to seek further surcharges of Zions’s collateral. The trustee then filed several motions to sell the debtors’ assets, including Zions’s collateral, and recover from Zions the administrative expenses incurred in the sales.

The debtors and their counsel objected to the stipulation because the debtors’ counsel had substantial unpaid fees from the earlier chapter 11 case for which they asserted a surcharge claim against Zions’s collateral under §506(c), and further argued that the trustee was not entitled to any compensation or surcharge against Zions’s collateral until all professional-fee applications were considered. The bankruptcy court rejected the surcharge claim of the debtors and their counsel and entered an order approving the stipulation and the surcharge of Zions’s collateral previously agreed upon between Zions and the trustee. There was no appeal from this order.

The trustee and Zions then agreed to another surcharge of Zions’s collateral in full satisfaction of all §506(c) claims that could have been asserted by the trustee and the debtors’ estates against Zions or its collateral. The debtors’ professionals again objected, claiming they had incurred expenses that would qualify for surcharge under §506(c). The court entered an order approving the surcharge in favor of the trustee and the §506(c) surcharge waiver in favor of Zions, from which there was no appeal.

The debtors and their counsel filed motions to surcharge Zions’s remaining cash collateral for their counsels’ outstanding fees and compel the trustee to prosecute a §506(c)
expenses were entitled to payment on a pro rata basis with the trustee’s surcharge claim.

Enforceability of §506(c): Surcharge Waiver in Final Court Orders

The Tenth Circuit BAP considered the enforceability of the §506(c) waivers approved by the bankruptcy court as an issue of first impression. The court upheld the enforceability of a §506(c) waiver based on the doctrine of res judicata. According to the res judicata doctrine, a final judgment on the merits of an action precludes the litigation of issues that were or could have been raised in that action in order to relieve the parties of burdensome multiple lawsuits and inconsistent decisions. See Allen v. McCurry, 449 U.S. 90, 94, 101 S.Ct. 411, 66 L.Ed.2d 308 (1980) (citing Cromwell v. Sac County, 94 U.S. 351, 352, 24 L.Ed. 195 (1876)). A party seeking to avail itself of res judicata must prove all of the following: (1) there was entry of a final judgment on the merits of the prior action, (2) the claims raised in the subsequent action were identical to those decided in the prior action and (3) the prior action involved the same parties. Court-approved settlements and litigated judgments enjoy the same res judicata treatment. See Hoxworth v. Blinder, 74 F.3d 205 (10th Cir. 1996).

The court relied on In re Molten Metal Technology Inc., 244 B.R. 515 (Bank. D. Mass. 2000), for upholding a prior court-approved waiver of a §506(c) surcharge claim based on res judicata. In Molten Metal, a §506(c) surcharge waiver was included in the financing orders approved by the bankruptcy court. Eleven former employees of the debtors asserted §506(c) surcharge claims totaling $595,104.27 for severance payments the debtors had agreed to pay under post-petition employee retention agreements. The employees argued that they were entitled to recover their severance claims from the proceeds of the lender’s collateral as reasonable and necessary costs of preserving the value of the collateral. They also contended that the §506(c) surcharge waiver contained in the prior court-approved financing order was contrary to public policy and, thus, invalid and unenforceable. They also argued they were not bound by the waivers because they were not parties to the agreements containing the waivers.

The court denied the employees’ §506(c) claims, upholding the enforceability of the §506(c) waiver. The waiver was approved by, and contained in an order of, the bankruptcy court. By virtue of res judicata, the waiver was enforceable against the DIPs, trustee and those persons served with the motions for approval of the waiver, regardless of any public policy considerations, the Code and the interests of the estate.

The court also rejected the employees’ argument that they were not bound by the §506(c) waivers because they were not parties to the agreements containing the waivers. Section 506(c) grants a trustee the right to assert a §506(c) surcharge claim. The trustee and DIPs had waived their §506(c) claims in exchange for the lender’s concessions agreed to as part of its financing arrangement negotiated with the debtors, including a substantial carve-out for the benefit of administrative creditors. The trustee’s ability to exercise his §506(c) rights would be undermined if the employees, as third-party claimants, could assert §506(c) claims independently of, and inconsistently with, the position espoused by the trustee. Also, the employees had constructive notice of the §506(c) waivers that were contained in prior court orders to which they had access and the opportunity to review.

In the InteliQuest Media case, the Tenth Circuit BAP also found that the trustee and Zions had satisfied the requirements for res judicata. Zions and the debtors had previously entered into a court-approved chapter 11 financing arrangement that included a waiver of all §506(c) surcharge claims. Neither the preliminary nor the final financing order that included a §506(c) surcharge waiver was the subject of an appeal. In addition, the trustee and Zions had entered into court-approved agreements that precluded the assertion of any surcharge claims against Zions’s collateral, except the previously negotiated surcharge in favor of the trustee, and no appeals were taken from these orders. The debtors had raised the same issues in their §506(c) surcharge claim against Zions as they had raised in their earlier objections, denied by the bankruptcy court, to the prior court-approved §506(c) waivers in favor of Zions. In addition, the same parties, Zions, the trustee, and debtors and their counsel, were involved in all these matters.1

The court was also concerned that overturning the previously court-approved §506(c) waivers threatened the successful administration of chapter 11 estates. Secured creditors would be less likely to enter into chapter 11 financing or cash-collateral agreements if they were concerned that the court-approved rights they had negotiated, such as a §506(c) surcharge waiver, could be later undone.

The court also rejected the argument that §506(c) requires a pro rata sharing of assets among administrative claimants. A §506(c) surcharge and §503(b) administrative expense claim are different charges that serve different purposes. An administrative expense claim is an assessment against the debtor’s estate and assets because it benefits all creditors. A §506(c) surcharge claim is a charge against a secured creditor’s collateral as reimbursement for a particular benefit to that creditor, which is paid from the secured creditor’s collateral and not from the assets of the debtor’s estate.

Finally, the court had little sympathy for the debtors and their counsel who chose not to seek protection for payment of counsel fees. They could have negotiated the payment of a retainer or for a carve-out for their counsel fees from Zions’s collateral as part of the original financing and later arrangements. Their failure to do so should not be mitigated by a belated renegotiation of the §506(c) waiver that Zions had negotiated first with the debtors as part of the chapter 11 financing arrangement, and then with the trustee in connection with the disposition of Zions’s collateral.


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1 The court also found the decision of a panel of the Eighth Circuit in In re Hen House Interstate Inc., 177 F.3d 719 (8th Cir. 1999) (Hen House I), relying upon the debtors, to be irrelevant. While the Eighth Circuit panel that decided Hen House I disregarded a prior court-approved §506(c) waiver, the Eighth Circuit later vacated the order in Hen House I. Thereafter, the Eighth Circuit on en banc ruled that only the trustee has standing to pursue a §506(c) surcharge claim. See In re Hen House Interstate Inc., 177 F.3d 719 (8th Cir. 1999). This was upheld by the U.S. Supreme Court in Hartford Underwriters Insurance Co. v. Union Planters Bank N.A., 530 U.S. 1, 120 S.Ct. 1942, 147 L.Ed.2d 1 (2000).