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Paying-To-Play in Chapter 11

Sally McDonald Henry

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PAYING-TO-PLAY IN CHAPTER 11

*Sally McDonald Henry**

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I. INTRODUCTION

Many secured creditors have decided that Chapter 11 is the place to be to liquidate their collateral. Judge Thomas Ambro of the Third Circuit Court of Appeals recently explained

11 U.S.C. § 363 allows a debtor to sell substantially all of its assets outside a plan of reorganization. In modern bankruptcy practice, it is the tool of choice to put a quick close to a bankruptcy case. It avoids time, expense, and, some would say, the Bankruptcy Code's unbending rules.¹

Judge Ambro should know what he's speaking about: he's the author of some of the most important bankruptcy law decisions of the Third Circuit since he joined the bench,² he is the former head of the Business Law Section of the American Bar Association,³ and he practiced bankruptcy law in Delaware – an important venue for large Chapter 11 cases⁴ – before he became a judge.⁵

But just because secured creditors want to use bankruptcy to liquidate their collateral does not mean, however, that they want to bear the costs: in other words, they oftentimes don't want to pay-to-play. Instead, they usually cut a deal in the first month of a bankruptcy case designed to protect themselves from bearing the costs of liquidating their collateral in Chapter 11. Oftentimes the deal includes the requirement that their collateral be sold swiftly, in a going concern sale. Indeed, reported cases increasingly reflect secured creditors apparently choosing Chapter 11 but purposefully walking away from the costs of estate

¹ *In re LCI Holding Co.*, 802 F.3d 547, 549 (3d Cir. 2015).

² *E.g.*, *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005) (noting substantive consolidation of claims of secured creditors is akin to communism); *In re Philadelphia Newspapers*, 599 F.3d 298, 321 (3d Cir. 2010) (Ambro, J. dissenting) (secured creditors have right to credit bid under § 1129(b)(1)).

³ Member Spotlight: An Interview with Judge Thomas Ambro (2015), available at www.americanbar.org/publications/bit/2015/10/member_spotlight.html.

⁴ Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L. J. 591, 599 (2012) (noting large percentage of Chapter 11 cases of debtors with greater than \$100 million in assets in 1980 dollars filed in Delaware between 1982 and 2011).

⁵ *E.g.*, *In re Marvel Ent. Group Inc.*, 234 B.R. 21 (Bankr. D. Del. 1999) (appearing as counsel to secured creditors).

administration.⁶ This article argues that secured creditors should *pay-to-play* in Chapter 11. In short, if secured creditors choose to liquidate their collateral in Chapter 11, they must pay all administrative expenses unless the estate has other available assets to meet those expenses.

In this article, I develop ideas initially proposed in my article, *Chapter 11 Zombies*, in which I described the increasing number of Chapter 11 dismissals in which distributions are made to secured creditors in a manner contrary to the explicit priority and equality of treatment rules of the Code. Herein, I develop some of the concerns I identified in *Chapter 11 Zombies* and suggest that the most appropriate way to discourage Chapter 11 distributions that violate the Chapter 11 distribution schemes is to forbid the entry of orders at the outset of a case that absolve secured creditors of their obligations under sections 506(c) and 552(a) of Chapter 11. These orders oftentimes have the practical effect, of allowing secured creditors to dictate who gets paid and in what amount in the chapter 11 case.

The good news is that the Bankruptcy Code does not have to be amended to provide for this fundamentally fair result. The Code already has two provisions that, properly interpreted, require the secured creditor pay-to-play. Those sections are Code sections 506(c) and 552. Code section 506(c) allows the estate to recover the reasonable and necessary costs of liquidating the secured creditors' collateral to the extent the secured creditor is benefited.⁷ Code section 552 allows a bankruptcy judge to cut off a security interest in proceeds to the extent that is an equitable outcome.⁸ As set forth below, these sections oftentimes are not used appropriately when the estate waives its right to the benefit of these sections within the first month of a case. I argue herein that courts should not approve those waivers so that the remedies under those sections can be applied in appropriate cases to impose the costs of administration on a secured creditor that is using Chapter 11 to liquidate its collateral.

Part I of the article explains the choices that a secured creditor

⁶ *E.g.*, *In re LCI Holding Co.*, 802 F.3d 547 (3d Cir. 2015) (before the Chapter 11 case, secured creditor negotiated a deal to pay some professionals and to pay wind-down costs associated with selling its collateral in Chapter 11, but refused to pay other expenses of case administration even though the estate was insolvent: Third Circuit approved “gifting” structure that left administrative tax claims unpaid); *see generally In re Petersburg Regency, LLC*, 540 B.R. 503 (Bankr. D.N.J. 2015) (carve out for all administrative creditors topped at \$150,000; initially settlement contemplated not paying IRS priority and administrative claim; settlement revised to pay IRS claims).

⁷ 11 U.S.C. § 506(c) (1978).

⁸ 11 U.S.C. § 552(b) (1978).

faces with respect to the disposition of its collateral when it has a blanket lien on the assets of a debtor. Part II illustrates the problem of secured creditors using Chapter 11 to liquidate their collateral and not paying all the expenses of case administration. Part III describes the roles of sections 506(c) and 552(b), and describes how secured creditors routinely obtain a waiver of a Code section 506(c) surcharge and the application of the equitable exception to its continuing security interest in proceeds provided for in section 552(b) at the outset of a Chapter 11 case. Part IV explains that these releases are entered into without compliance with the normal requirements for debtors' releasing claims. Part IV also establishes that if the normal requirements were followed, the court usually could not approve the 506(c) and 552(b) waivers. Finally, Part V proposes a bright line test for determining when secured creditors should be liable for administrative expenses: if the secured creditor's collateral is liquidated in a Chapter 11 case as a going concern, the secured creditor should be liable for administrative expenses of the case if its assets are not otherwise available to pay those expenses. This rule balances the interest of the estate and the secured lender by allowing a secured lender to determine for itself whether it believes the costs of administration are beneficial to it. It preserves for the secured creditor the benefit of its bargain—to be able to use foreclosure under Article 9 of the Uniform Commercial Code—while simultaneously protecting administrative creditors from being used by the secured creditor without being compensated.

II. THE SECURED CREDITOR'S CHOICE

The cases in which Chapter 11 administrative creditors are short-changed are typically cases that are converted to Chapter 7 after substantially all the assets of the estate have been sold, or that culminate in “structured dismissals”—cases in which the assets of the debtor are sold and the case is dismissed with court orders previously entered remaining in effect. These cases are increasingly common,⁹ and

⁹ Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative After Asset Sales*, AM. BANKR. INST. J. 1, (June 2010); Official Comm. of Unsecured Creditors v. CIT Grp./Res. Credit Inc. (*In re Jevic Holding Corp.*), 787 F.3d 173 (3d Cir. 2015) (The Supreme Court has granted certiorari in the Jevic case, but the question presented is not whether all structured dismissals are inappropriate; rather, the question is whether a structured dismissal in which the estate's assets are distributed in a manner contrary to Code section 507 is appropriate. Accordingly, putting aside the

oftentimes involve under-secured creditors. When a creditor is under-secured, the creditor has four options for realizing on its collateral: (1) a traditional Chapter 11 case in which it funds administrative and priority claims in full in order to allow the debtor to confirm a reorganization plan; (2) a Chapter 7 case, in which it can either (a) push the Chapter 7 trustee to abandon the collateral as soon as possible, or failing that, move to lift the automatic stay¹⁰ so that it can proceed with its state law remedies, or (b) cooperate with the Chapter 7 trustee to sell the collateral out of Chapter 7; (3) recover the collateral in accordance with the options available under Article 9 of the Uniform Commercial Code; or (4) cooperate in a Chapter 11 case that concludes with a structured dismissal in which the collateral is sold—often as a going concern sale—and the case subsequently dismissed with all orders staying in place.¹¹ In the last option, the secured creditor would typically be cooperating because, in a case in which a plan cannot be confirmed, the secured creditor would have a good cause to lift the automatic stay to proceed with a state law foreclosure on its collateral.¹²

These are not great choices, but being under-secured with a lien on an operating business is not a great position to be in either.

A traditional Chapter 11 case is expensive: in order to confirm a plan, administrative claims must be paid,¹³ priority claims must be paid,¹⁴ a plan and disclosure statement must be drafted and approved.¹⁵ Critically, the plan cannot be confirmed unless an impaired class accepts the plan¹⁶ (because unsecured creditors will not be paid in full on the

potential for extremely expansive dicta from the Supreme Court that is then followed by the lower courts, the issues relating to structured dismissals will continue to be important notwithstanding the Supreme Court's decision in *Jevic*.)

¹⁰ The “automatic stay” of 11 U.S.C. § 362(a) prohibits many creditor actions to recover on their prepetition claims. A creditor can move to lift the stay for cause. 11 U.S.C. § 362(d).

¹¹ 11 U.S.C. § 1112 provides for the dismissal of a Chapter 11 case; 11 U.S.C. § 349(b) has been interpreted to allow pre-dismissal orders entered in a Chapter 11 case to remain in effect.

¹² See 11 U.S.C. § 362(d).

¹³ 11 U.S.C. § 1129(a)(9)(A) (providing that, absent consent of the creditor, administrative claims must be paid in full in order to confirm a reorganization plan).

¹⁴ 11 U.S.C. § 1129(a)(9)(B)-(C).

¹⁵ 11 U.S.C. §§ 1125-1129. In limited cases, the plan can serve as a disclosure statement. 11 U.S.C. § 1125(f).

¹⁶ 11 U.S.C. § 1129(a)(10).

plan's effective date, the plan will have at least one impaired class).¹⁷ Confirming a plan is an option that only makes sense if the secured creditor is convinced that the going concern value of a sale under Chapter 11 is so much greater than the costs of confirming a plan that it makes sense to proceed in this manner. This option might make sense when the business needs a great deal of cleanup in Chapter 11 and administrative and priority claims are not disproportionately high compared to the perceived advantages of a cleanup. This may be the only option if the business needs substantial restructuring that is only available in Chapter 11, and the court is disinclined to enter a novel *structured dismissal* order that is broad enough to address the secured creditor's concerns relating to its collateral. In this option, by definition the secured creditor must pay-to-play, because a case cannot be confirmed without paying all administrative and priority claims.¹⁸

Another choice, liquidating collateral in a Chapter 7 case, oftentimes is a horrible option. Chapter 7 trustees will sell collateral for the benefit of a secured creditor, but they understandably want to be paid for that work and show some benefit to other creditors. While Chapter 7 trustees can sell debtors' businesses as going concerns—the *Refco* cases and the *Lehman Brothers* cases illustrate that—such sales are rare.¹⁹ Both the *Refco* sales and the *Lehman Brothers* sales took place in unusual cases that were highly choreographed, and such Chapter 7 cases are not a usual option. Although Chapter 7 trustees can theoretically operate a business post-filing,²⁰ that is not their key expertise. Rather, they often are more adept at suing secured creditors. In short, a Chapter 7 disposition is seldom an attractive option.

A third choice may be state law remedies, but again, that can be

¹⁷ See 11 U.S.C. § 1124 (explaining the term “impaired”).

¹⁸ 11 U.S.C. § 1129(a)(9).

¹⁹ *In re Refco, LLC*, 05-60134 (RDD) (Bankr. S.D.N.Y. 2005), Order Authorizing Chapter 7 Trustee to Assume and Perform Acquisition Agreement, Sell the Regulated Futures Commission Merchant Business and Assume and Assign Certain Related Executory Contracts, Nov. 25, 2005, ECF 10; *In re Refco, LLC*, 05-60134 (RDD) (Bankr. S.D.N.Y. 2005), Order Authorizing Chapter 7 Trustee to Operate Business of Refco, LLC for a Limited Period and Granting Related Relief, Nov. 25, 2005, ECF. 9; *In re Lehman Brothers Holdings, Inc.*, 08-13555 (JMP) (Bankr. S.D.N.Y. 2008), Order Under 11 U.S.C. §§ 105(a), 363, and 365 and Federal Rules of Bankruptcy Procedure 2002, 6004, and 6006 Authorizing and Approving (A) the Sale of Purchased Assets Free and Clear of Liens and Other Interests and (B) Assumption and Assignment of Executory Contracts and Unexpired Leases, Sept. 20, 2008, ECF 258.

²⁰ 11 U.S.C. § 721 (allowing chapter 7 trustee to operate business).

an unattractive choice. Unless the blanket lien is structured so that the diverse assets are held in a legally separate entity (a “Holdco”), in which case the foreclosure/strict foreclosure process can be accomplished with a stock transfer for the most part, the assets might go through a potentially messy foreclosure in which the creditor might lose value and, temporary, control. More importantly, the state law option also forgoes any of the benefits of a bankruptcy case, such as the ability to reject executory contracts²¹ and leave obligations behind.²² Closely related to these state law remedies are the two options of (1) negotiating relief from the automatic stay or abandonment of the collateral with the estate representative (be it a Chapter 11 trustee, a Chapter 7 trustee, or a debtor in possession); or moving to lift the automatic stay to foreclose on the collateral in state court. All the detriments described earlier in this section are concerns, because a creditor faces the possibility of battles in multiple venues: at the least in a lift stay motion, a creditor could face a Chapter 7 litigation to be followed by a state law quagmire.

That leaves the option of participating in a Chapter 11 case in which the company is sold as a going concern, and the case is dismissed without a plan having been confirmed. For many under-secured creditors this is an attractive option if the court is willing to allow this use of the Bankruptcy Code.²³ Secured creditors can take advantage of a free and clear order from the bankruptcy court,²⁴ they can leave behind unwanted claims, they can reject the contracts or leases the business does not want and leave the associated claims behind. Some courts even allow more aggressive use of a structured dismissal, such as the incorporation of exculpation provisions or releases in the dismissal order that avoid post-case litigation. This alone could be enough of a difference from a state

²¹ 11 U.S.C. § 365(a) (allowing trustee to assume or reject any executor contract).

²² 11 U.S.C. § 363(f) (allowing for the sale of estate assets “free and clear of any interest in such property of any entity other than the estate” if certain criteria are met).

²³ The structured dismissal option has been approved by the Third Circuit in a recent case for which certiorari has been granted. *Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit, Inc. In re Jevic Holdings Co.*, 787 F.3d 173 (3d Cir. 2015), *cert. granted*, 136 S. Ct. 2541 (2016). The question presented to the Supreme Court is not whether a structured dismissal is allowed, but rather whether a dismissal that pays creditors in a manner contrary to the requirements of Code section 507 is allowable.

²⁴ A “free and clear order” is entered under section 363(f) of the Bankruptcy Code.

law liquidation to make a Chapter 11 dismissal case attractive.²⁵

So what are secured creditors choosing? We have no definitive answers statistically, but the case law reflects that creditors increasingly are choosing the structured dismissal.²⁶ In those cases, and in cases in which a going concern sale occurs, and the case is later converted to a Chapter 7 case, the secured creditor should, at a minimum, be liable for all the costs of administration if other assets are not available to pay those claims.²⁷

III. THE PROBLEM ILLUSTRATED

The problem of secured creditors not wanting to pay-to-play is illustrated by a recent case from the Third Circuit, *LCI Holding Co.*,²⁸ that may prove to be a roadmap for secured creditors to stiff administrative creditors in the same manner that the LCI secured creditor managed to stiff an administrative creditor in that case. In *LCI*, the secured creditor, which had a so-called *blanket lien* on the debtors' assets,²⁹ negotiated the use of Chapter 11 prepetition in order to liquidate its collateral. The outcome of that negotiation was that the secured creditor would pay certain professional expenses, pay agreed-upon wind down expenses, and credit bid a portion of its claim to acquire the

²⁵ See Pernick & Dean, *supra*, note 9.

²⁶ *In re Petersberg Regency, LLC*, 540 B.R. 503 (Bankr. D. N.J. 2015) (approving structured dismissal); *In re Naartjie Custom Kids, Inc.*, 534 B.R. 416 (Bankr. D. Utah 2015) (approving structured dismissal); *In re Buffet Partners, L.P.*, Case No. 14-30699-HDH-11 (July 28, 2014), 2014 Bankr. LEXIS 3204 (N.D. Texas 2014) (approving structured dismissal); *In re Biolitec*, 528 B.R. 261, 272 (Bankr. N.J. 2014) (debtor requested structured dismissal, which court would not approve); *In re Strategic Labor, Inc.*, 476 B.R. 11 (Bankr. D. Mass. 2012) (converting case to Chapter 7 and refusing to enter structured dismissal order in light of the debtor's wrongdoing). A number of unreported cases are also structured dismissals. *E.g.*, *In re LCI Holdings, Corp.*, Case No. 12-13319 (KG) (Bankr. D. Del.), Order Granting Debtors' Motion for Entry of Order Pursuant to 11 U.S.C. § 105(a), 305(a), 349 and 112(b) and Fed. R. Bankr. P. 1017(a) (A) Dismissing the Debtors' Chapter 11 Cases and (B) Granting Related Relief, Jan. 24, 2014, ECF No. 1137.

²⁷ In appropriate cases, the secured creditor should also be liable for all priority claims of employees, because it is the employees that have enhanced the going concern value of the company. In many cases, the secured creditor will agree to an order to be entered at the beginning of the case that will pay outstanding wages and some, if not all, outstanding benefits.

²⁸ See 802 F.3d 547 (3d Cir. 2015).

²⁹ The debtors consisted of thirty-five related companies. *Id.* at 550.

debtors' assets,³⁰ after which the Chapter 11 case would be dismissed. The motion to approve a sale would be sought at the inception of the case.³¹ From the very outset of the case, the deal was that the secured creditor would have no liability for the costs of liquidating its collateral that it did not choose to assume; the financing order entered shortly after the case was filed provided both that the estate could not recover from the prepetition lenders under Code section 506(c) and that the "equities of the case" exception to their continuing security interest in proceeds could not be applied to them.³²

Although the secured creditor had agreed to pay some wind down expenses, the secured creditor did not agree to pay a large administrative tax claim, and it continued to refuse to pay this administrative claim even after an administrative creditor objected.³³ Eventually, the secured creditor recut the deal to make a small payment to unsecured creditors,³⁴ but it still refused to pay a large outstanding administrative tax claim. Based on the so-called *gifting* theory, the Third Circuit affirmed the order providing for the disposition of assets on these terms.³⁵

Because the Third Circuit hears appeals from the District of Delaware, and because Delaware has a disproportionate number of large Chapter 11 cases, this decision could have a great impact on liquidations going forward.

The loss of value to creditors that are not secured creditors has troubled Chapter 11 scholars. Scholars fear that when a case conducts a sale of substantially all of the assets of the estate early in the case, the property will be sold for less than fair market value, and under-secured creditors will still be shortchanged. In their well-known article, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11*,³⁶ Melissa B. Jacoby and Edward J. Janger suggest that one way to address the problem is to provide for a holdback in the form of a bond available for

³⁰ *Id.*

³¹ *Id.* at 550-51.

³² *In re* LCI Holding, Co., 12-13319-KC (Bankr. D. Del. Jan. 23, 2013), Final Order Under 11 U.S.C. §§ 105, 361, 362, 363(c), 363(m), 364(c)(1), 364(c)2), 364(c)(3), 364(d)(1), 364(e) and 507 and Bankruptcy Rules 2002, 4001, and 9014 Authorizing the Debtors to Obtain Postpetition Financing, (II) Authorizing the Debtors to Use Cash Collateral, and (III) Granting Adequate Protection to Prepetition Secured Lenders, ¶¶ 12, 13, Jan. 23, 2013, ECF No. 0291.

³³ *Id.* at 551.

³⁴ *Id.*

³⁵ *Id.* at 557-58 & n. 6.

³⁶ 133 YALE L. REV. 862, 873 (2013)

distribution to creditors if the estate assets (justified on the theory that the estate was a melting ice cube) were undervalued in a quick sale. In a follow-up article, *The Logic and Limit of Liens*,³⁷ Professor Janger suggests that protection for unsecured creditors can be found in Code section 552, but he does not address the problem that arises from the protections of Code section 552 (to be described below) being routinely waived at the inception of a case, and thus naturally he posits no suggestion for addressing the problem of the 552 “equities of the case” right having been waived routinely before the case is underway.

IV. CODE SECTIONS 506(C) AND 552

A. Code Section 506(c)

Section 506(c) of the Bankruptcy Code provides that the collateral of a secured creditor can be surcharged. In other words, certain expenses incurred by the estate can be paid out of the proceeds of the disposition of the collateral. That section provides:

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, including the payment of all ad valorem property taxes with respect to the property.³⁸

The statute therefore has three requirements for imposing a surcharge for preserving or disposing of the secured creditors’ property: the expense must be (1) necessary; (2) reasonable; and (3) limited to the extent to the benefit to the holder of the secured claim.

Notwithstanding the plain language of the Code and the Supreme Court’s repeated emphasis on respecting the plain language of codified laws, courts have imposed additional requirements to impose a surcharge: most notably, many courts hold that the expenditure must have been, at the time it was made, *primarily* for the benefit of the holder of the claim unless the secured creditor caused or consented to the expenditures.³⁹ This language represents judicial requirements that go

³⁷ 2015 ILL. L. REV. ONLINE 589, 600, available at <https://perma.cc/AF37-6S6B>.

³⁸ 11 U.S.C. § 506(c) (1978).

³⁹ *E.g.*, *In re Cascade Hydraulics & Utility Service, Inc.*, 815 F. 2d 546, 548 (9th

beyond the statutory language: the legislative history explains that “[a]ny time the trustee . . . expends money to provide for the reasonable and necessary cost and expenses of preserving or disposing of a secured creditor’s collateral, the trustee . . . is entitled to recover such expenses from the secured party or from property” of the estate.⁴⁰

These cases reflect a reluctance of the courts to impose a surcharge on secured creditors. Notably, however, the circuit level case law regarding 506(c) is clustered in the early 1980’s and seldom involve cases in which the creditor has a so-called “blanket lien,” covering much of the collateral.⁴¹

While a number of cases have held that the surcharge has to be primarily for the benefit of the secured creditor, recent case law takes a more practical approach. In *Southwest Sec. FSB v. Segner (In re Domistyle, Inc.)*,⁴² the Fifth Circuit Court of Appeals held that expenses incurred by a trustee prior to moving to abandon estate property could be charged against the secured creditor. In so doing, it emphasized that a judicially-crafted rule that only allowed the surcharge of expenses in the period between the time a trustee had filed a motion to abandon the property and the time the secured creditor did not oppose abandonment was an artificial test that was inconsistent with the statutory language.⁴³

Although the courts are not uniform on when § 506(c) should be

Cir. 1987); *In re Trim-X, Inc.*, 695 F.2d 296, 301 (7th Cir. 1982).

⁴⁰ 124 Cong. Rec. H32,398 (daily ed. Sept. 28, 1978) (represented in 1978 U.S.C.A.N. 6436, 6451).

⁴¹ *United Jersey Bank v. Miller (In re C.S. Assocs.)*, 29 F.3d 903, 906 (3d Cir. 1994) (expenses must provide “direct benefit” to the secured creditor); *United States v. Boatman’s First Nat’l Bank*, 5 F.3d 1157 (8th Cir. 1993) (workers’ compensation insurance and payroll taxes are subject to 506(c) surcharge; as a going concern, creditor likely received a greater recovery); *Credit Bank of Montana v. Cascade Hydraulics and Utility Service, Inc. (In re Cascade Hydraulics & Utility Service, Inc.)*, 815 F. 2d 546 (9th Cir. 1987)(secured creditor cannot be surcharged when company failed to confirm reorganization plan and had to revise the plan to liquidate); *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 76 (2d Cir. 1984); *Brookfield Production Credit Association v. Borron*, 738 F.2d 951, 952 (8th Cir. 1984); *In re Trim-X, Inc.*, 695 F.2d 296, 301 (7th Cir. 1982)(expenses of preserving assets from the date trustee was appointed until the date that the trustee could have abandoned the property were necessary expenses but the only expenses that “benefitted the secured creditor were those that arose after the motion to abandon the assets).

⁴² 811 F.3d 691, 696-700 (5th Cir. 2015).

⁴³ *Id.* at 699.

allowed to surcharge a secured creditor, one aspect of the § 506(c) puzzle is clear. It is the estate (be it a trustee or a debtor in possession) that has the right to seek a surcharge. The Code specifically states that “a trustee can recover” the surcharge,⁴⁴ and the Supreme Court held in 2000 that the plain words of the statute controlled. In *Hartford Underwriters Ins. Co. v. Union Planters Bank*,⁴⁵ the court held that a creditor itself could not bring an action to recover expenses under Code section 506(c). The Court did leave open one window, however; it left for another day the issue of whether a creditors’ committee or another entity acting on behalf of the estate could bring a derivative action to surcharge collateral.⁴⁶ That opening is important because in many cases it is the creditors committee (or a litigation trustee established under a Chapter 11 plan) that brings actions to enforce causes of actions of the estate.

Notwithstanding the Code’s providing for a surcharge of the secured creditor in appropriate cases, a surcharge is rarely imposed in Chapter 11 cases. That is because a waiver of the right to recover a surcharge under section 506(c) is the norm in large Chapter 11 cases. It is very common in Chapter 11 cases under the local rules of the District of Delaware, in which many of these large cases are filed, which has a special provision about the 506(c) waiver.⁴⁷

The waiver is typically set forth in an order allowing the debtor to use the creditor’s cash collateral or in an order providing for the debtor to obtain financing. It is typically entered within the first month of a Chapter 11 case before many constituents know the direction the case is likely to take.⁴⁸ Even though courts routinely approve this waiver, a few courts are reluctant.⁴⁹

⁴⁴ § 506(c). Elsewhere, the Code provides that a debtor-in-possession—the term for a debtor in a Chapter 11 case when a Chapter 11 trustee has not been appointed—has all the powers and duties of a trustee, with limited exceptions not relevant here. 11 U.S.C. § 1107(a).

⁴⁵ 530 U.S. 1, 9 (2000).

⁴⁶ *Id.* at 13, n.5.

⁴⁷ Del. Bankr. Ct. Loc. R. 4001-2(a)(i)(C) (Feb. 1, 2016) (necessity of highlighting § 506(c) waiver in financing or cash collateral pleadings).

⁴⁸ Marcia L. Goldstein & Victoria Vron, *Current Issues in Debtor in Possession Financing*, SK092 ALI-ABA 115 (June 2005).

⁴⁹ *McAlpine v. Comerica Bank-Detroit (In re Brown Brothers, Inc.)*, 136 B.R. 470, 474 (W.D. Mich. 1991); *In re The Colad Group, Inc.*, 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005) (refusing to approve 506(c) waiver provision in debtor-in-possession financing); *In re Ridgeline Structures, Inc.*, 154 B.R. 831, 832 (Bankr. D. N.H. 1993) (stipulation waiving surcharge “no matter what action, inaction, or acquiescence by [the secured party] might occur” and which failed

Here is a 506(c) waiver from the *General Motors'* Chapter 11 case:

[E]xcept to the extent of the Carve Out, no expenses of administration of the cases or any future proceeding that may result therefrom . . . shall be charged against or recovered from the Collateral pursuant to section 506(c) of the Bankruptcy Code or any similar principle of law⁵⁰

Courts enter orders providing for the waiver because the orders in which the § 506(c) waiver appears are so critically important to a Chapter 11 case. Whether a debtor is liquidating or attempting to reorganize, the debtor needs cash. These days, because creditors often have a blanket lien on all the debtors' assets,⁵¹ the debtor entering Chapter 11 likely has no free cash. Cash that might appear to be unencumbered in fact could be the proceeds of collateral or subject to the security interest of the bank in which an account is located.⁵² Therefore, to enable a debtor to operate its business, the debtor needs either to obtain a post-petition debtor-in-possession financing facility or needs to obtain permission to use cash collateral, because the Bankruptcy Code forbids the debtor in possession from using cash collateral without court authorization.⁵³

to be on proper notice was unenforceable per se as being against public policy).

⁵⁰ *In re General Motors*, 09-500026 (REG), Interim Order Under 11 U.S.C. §§ 105, 361, 363, 363 and Fed. R. Bankr. P. 2002, 4001 and 9014 (I) Authorizing Debtors to Use Cash Collateral, (II) Granting Adequate Protection to Pre-petition Revolver Secured Parties and (III) Scheduling a Final Hearing Pursuant to Bankruptcy Rule 4001(b), June 1, 2009, ECF 180.

⁵¹ Janger, *supra* note 37, at 596 (“loan documents are often structured to manifest an intention to encumber all assets in favor of a secured lender. . . This package of conveyances is then described as a “blanket lien”). Professor Janger argues in this article that Code section 552(b) should be broadly construed in appropriate circumstances. I agree with that conclusion, but believe that the first step to giving weight to section 552(b) is to prohibit its waiver at the outset of a case.

⁵² *Id.* at 595-96 (describing how lenders contend that all the debtor's assets are subject to their liens or are the proceeds of their liens).

⁵³ 11 U.S.C. § 363(c)(2) provides that “the trustee . . . may not use . . . cash collateral unless:

(A) each entity that has an interest in such cash collateral consents; or

Accordingly, in all but the most abnormal cases, the debtor will negotiate a debtor-in-possession financing (“DIP financing” in the lingo of the trade), or a cash collateral agreement with lenders.⁵⁴ The cash collateral order is by definition negotiated with the prepetition lenders; the DIP financing order is oftentimes negotiated with the debtors’ prepetition lenders. In virtually all cases, the financing or cash collateral facility will provide for two things: a “carve out” for professionals and a § 506(c) waiver.⁵⁵

The carve out is designed to guarantee professionals who work for the debtor that they will be paid if the debtor is administratively insolvent. That is especially important these days when all the debtors’ assets may be encumbered. The carve out typically provides that the debtors’ professionals (and oftentimes the creditors’ committees’ professionals) will be paid out of the secured creditors collateral even if the estate is administratively insolvent. In effect, the carve out is a negotiated provision for a surcharge that will kick in without litigation in the worst case scenario.⁵⁶

The financing or cash collateral agreements providing for a § 506(c) waiver are typically filed with the court on the first day of the case. Indeed, they are so common that the patois of the trade has named them “First Day Orders.” They are entered – again, oftentimes on the first day of a case—on an interim basis (although in many cases the § 506(c) waiver may not be effective until a final order is entered with greater notice). The bankruptcy rules specifically require that this type of financing order or cash collateral order in final form only be entered after

(B) the court, after notice and a hearing, authorizes such use. . . in accordance with the provisions of this section.

⁵⁴ Cash collateral includes “cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents . . . and includes the proceeds, products, offspring, rents or profits of property.” 11 U.S.C. § 363(a). A debtor may not use cash collateral without the consent of all creditors with security interests in the cash collateral without court authorization. 11 U.S.C. § 363(c)(2). The court must find that the secured creditor is adequately protected in order to authorize use of the cash collateral without the secured creditors’ consent. 11 U.S.C. § 361.

⁵⁵ David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 *CARDOZO L. REV.* 1905, 1929 (2004); George W. Kuney, *Hijacking Chapter 11*, 21 *EMORY BANKR. DEV. J.* 19, 67 (2004).

⁵⁶ For an overview of the case law on carve outs, see Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 *AM. BANKR. L.J.* 445 (2002).

creditors have received fourteen days' notice of the requested relief.⁵⁷

Why are these waivers included in the First Day Orders? The waivers are included because secured creditors are smart enough to ask for them. The debtor is desperate for cash and often has little leverage in the negotiations. Because the cause of action belongs to the debtor, one circuit court has even held that creditors cannot object to the § 506(c) waiver.⁵⁸ In any event, in the first month of a case, creditors may not even realize how important a 506(c) waiver may ultimately prove to be.

Once the waiver is provided for in an order, courts routinely enforce the waiver on the basis that the order is *res judicata*.⁵⁹

B. Code Section 552(b)

There is another potentially beneficial provision of the Bankruptcy Code that is typically waived in the first month of a bankruptcy case: a provision in Code section 552. That section provides:

(b)(1) Except as provided in sections . . . 506(c) . . . of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by

⁵⁷ Fed. R. Bankr. P. 4001 (a)(3).

⁵⁸ *In re Debbie Reynolds Hotel & Casino, Inc.*, 255 F.3d 1061, 1065-68 (9th Cir. 2001). This result does not really make sense because many avoidance actions (such as preference actions and fraudulent conveyance actions) are assigned to the trustee to bring. If a creditor could not object to the settlement of a cause of action that, by the terms of the Bankruptcy Code, the trustee is assigned to prosecute, then the trustee or debtor-in- possession would have *carte blanche* to settle avoidance actions.

⁵⁹ *In re IntelliQuest Media Corp.*, 326 B.R. 825, 830-31 (B.A.P. 10th Cir. 2005) (affirming order denying motion to compel trustee to bring an action under Code section 506(c) because debtors had entered into 506(c) waiver in financing orders); *In re Molten Metal Tech.*, 244 B.R. 515, 519 (Bankr. D. Mass. 2000) (section 506(c) waiver previously approved by the court enforceable as being *res judicata*); *In re Film Equipment Rental Co.*, No. 91 CIV.3476 (CSH), 1991 WL 274464, at *1, *3 (S.D.N.Y. 1991) (enforcing section 506(c) waiver).

such security agreement and by applicable nonbankruptcy law, except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.⁶⁰

This section of the Bankruptcy Code must be read with the Uniform Commercial Code in mind, because the U.C.C. specifically provides that a security interest in collateral automatically extends to proceeds.⁶¹ Therefore, by definition, all prepetition security interests should extend to proceeds unless the secured creditor and the debtor negotiated a different deal. The definition of proceeds is broad; indeed, it was amended in 2001 to include property that had not previously been within the scope of the definition.⁶²

In any event, like the typical provision waiving § 506(c) surcharges, this “equities of the case” exception to the continuing interest in proceeds is often waived at the outset of a case in a cash collateral order or a financing order. For example, in the *LCI Holding* case, described above, the final financing and cash collateral order provided: “the equities of the case” exception under § 552(b) of the Bankruptcy Code shall not apply to the Prepetition Agent and the Prepetition Lenders.⁶³

How common is the Code section 552 waiver? There is no empirical study of this, to the best of my knowledge, but it is so common that the venue of most large Chapter 11 cases, Delaware, has a local rule

⁶⁰ § 552(b)(1).

⁶¹ U.C.C. § 9-203(f) (Am. Law Inst. & Unif. Law Comm’n 2014) (“The attachment of a security interest in a collateral gives the secured party the rights to proceeds provided by Section 9-315 . . .”).

⁶² U.C.C. § 9-315 (defining proceeds). See G. Ray Warner, *Article 9’s Bankrupt Proceeds Rule: Amending Bankruptcy Code Section 552 Through the UCC “Proceeds” Definition*, 46 GONZAGA LAW. REV. 521 (2010-2011) (discussing Article 9’s expansion of the definition of proceeds); G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3 (2001). See *In re Bumper Sales, Inc.*, 907 F.2d 1430, 1437 (4th Cir. 1990) (noting that the term proceeds is not defined in the Bankruptcy Code and thus term should be defined in accordance with state law).

⁶³ *In re LCI Holding, Co.*, No.12-13319-KG, slip op. 2013 WL 1101111, at *1 (Bankr. D. Del. Mar. 15, 2013) (Under “11 U.S.C. §§ 105(a), 363, 507(a), 1107(a), and 1108 and Fed. R. Bankr. P. 6003, Authorizing [the] Debtors” to Obtain Postpetition Financing, (II) Authorizing the Debtors to Use Cash Collateral, and (III) Granting Adequate Protection to Prepetition Secured Lenders).

requiring that the provision be highlighted in any financing or cash collateral order, just as it requires the section 506(c) waiver to be highlighted.⁶⁴

Perhaps because so many cash collateral and financing orders provide for a section § 552 waiver, there is not a great body of case law delineating situations in which “the equities of the case” are such that it is appropriate to limit a secured creditor’s security interest in proceeds. Courts have explained that “the ‘equities of the case’ provision is intended to prevent secured creditors from receiving windfalls and to allow the bankruptcy courts broad discretion in balancing the interests of secured creditors against the general policy of the Bankruptcy Code.”⁶⁵ One of the relatively few cases, however, construing the “equities of the case” proceeds exception is *In re Photo Promotion Associates*.⁶⁶ There, the court relied on the equities of the case exception to section 552(b)(1) to limit the secured creditor’s interests in proceeds of its prepetition security interest in the debtors’ contracts because those proceeds had arisen through the expenditure of unencumbered property to complete the work to be done on the contracts.

Despite the comparative paucity of case law construing section 552(b)(1), in theory, the section could be a powerful tool to compensate the estate for the expenses it incurs in allowing a secured creditor to use Chapter 11 to enhance its recovery on its security interest. The phrase “equities of the case” is undefined, but it would seem to allow the estate to benefit from the recovery on proceeds of the secured creditor’s collateral if the estate would otherwise be unable to pay its administrative expenses.

The benefit of having both Code sections available for the recovery of administrative expenses from a secured creditor in an administratively insolvent case is that there is a well-developed body of case law construing Code section 506(c) that could be a barrier to a recovery in certain circuits. Thus, a circuit (such as the Seventh Circuit) that requires that an expenditure be primarily for the benefit of the secured creditor may not allow a charge against the collateral in a particular case. By contrast, an action to release proceeds under Code section 552(b) may have more possibility of success, given the standard that the proponent only has to show that the recovery is based on the equities of the case.

⁶⁴ Del. Bankr. Ct. Loc. R. 4001-2(a)(i)(H) (requiring highlighting of “provisions that seek to affect the court’s power to consider the equities of the case”).

⁶⁵ *In re Patio & Porch Sys.*, 194 B.R. 569, 575 (Bankr. D. Md. 1996).

⁶⁶ 61 B.R. 936, 939 (Bankr. S.D.N.Y. 1986).

V. SECTION 506(C) AND 552(b) WAIVERS GENERALLY SHOULD NOT BE APPROVED AT THE OUTSET OF A CHAPTER 11 CASE

Properly analyzed, the waivers of rights under 506(c) and 552 at the outset of the case are releases or settlements. The debtor is settling its claims against the secured creditor for the consideration of the cash collateral order or the financing order. Understand, though, that no section of the Bankruptcy Code specifically addresses the waiver of these rights in exchange for financing or the use of cash. Because these waivers are just releases or settlements, the propriety of the waivers, then, depends on the rules allowing debtors to release or settle claims.

Although debtors are allowed to release claims in a Chapter 11 plan under 11 U.S.C. § 1123(b)(3), no section of the Code specifically allows debtors to release claims outside of a reorganization plan. However, Bankruptcy Rule 9019 allows a debtor to settle claims.⁶⁷ In determining whether to approve a release, many courts consider (1) the probability of success in the litigation; (2) the difficulties in collecting a judgment; (3) the complexity of the litigation; (4) the expense, inconvenience and delay caused by the litigation; and (5) the paramount interest of creditors and deference to their reasonable views.⁶⁸ Some courts have even more demanding criteria for approving the debtor's release of claims.⁶⁹

Applying these criteria, the estate faces a high bar to waive 506(c) and 552(b) rights, a bar that an estate could rarely meet at the outset of a case.

⁶⁷ Fed. R. Bankr. P. 9019 provides that “[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement.”

⁶⁸ Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968); *In re LCI Holding Co.*, 802 F.3d 547, 551-52 (3d Cir. 2015); *In re Martin*, 91 F.3d 389, 393 (3d Cir. 1996); *In re Tower Auto., Inc.*, 241 F.R.D. 162 (S.D.N.Y. 2006); *In re Remsen Partners*, 294 B.R. 557, 565 (Bankr. S.D.N.Y. 2003).

⁶⁹ *In re Exide Techs.*, 303 B.R. 48, 71-74 (Bankr. D. Del. 2013) (articulating different standards for the debtors' release of claims than for the release of claims by a creditor against a third-party); *In re Zenith Elecs. Corp.*, 241 B.R. 92, 110 (Bankr. D. Del. 1999) (adopting Master Mortgage test for approving the debtor's release of claims); *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. 930, 937 (Bankr. W. D. Mo. 1994) (setting forth multi-part test that must be met to allow debtor to release claims). See generally, *In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2000) (declining to articulate standard for the debtor's release of estate claims against third parties).

A. Probability of Success in the Litigation

The estate cannot know the probability of success in sections 506(c) or 552(b) litigation at the outset of most cases. The expenses that the estate will incur are prospective; who can predict whether these yet-to-be-incurred expenses will be reasonable or necessary? Similarly, who can predict the amount to which the secured creditor will benefit from the expenses to be incurred? Admittedly, in some cases—those cases in which the DIP financing or cash collateral order provides for a brief timetable to sell estate assets and therefore the case seems to have as its primary goal the liquidation of the secured creditors' assets—the debtor may have a high probability of success in Code section 506(c) litigation, especially if it appears from the inception of the case that the creditor is undersecured. Similarly, because the critical question with respect to a Code section 552(b) determination is the “equities of the case,” it would normally be impossible to assess the equitable considerations during the first month of the case. Accordingly, this factor—probability of success in the litigation—will not support a court's approval of a § 506(c) or § 552(b) waiver in a DIP financing or cash collateral order entered early in a case.

B. Complexity of the Litigation

An action to recover costs under Code section § 506(c) is not a particularly complex litigation factually. Similarly, an action to avoid the secured creditor's interest in proceeds based on the equities of the case should not usually be particularly complex litigation. The key factual issue in a section 506(c) action is what costs the estate incurred (and the estate needs to keep track of its expenditures as part of its duties as debtor in possession in any case⁷⁰). Whether the secured creditor will benefit from the expenditures to be made later in the case is also an unknown. Who can predict how the case will develop? When the issue is ultimately litigated, the fact that the secured creditor may have failed to move for relief from the automatic stay strongly suggests the creditors made a determination about the benefit it would obtain from a bankruptcy sale, rather than from a state law foreclosure. In a 552(b) action, the question is what is equitable under the circumstances? This may not be extremely difficult determination in the type of case that is being addressed herein; a Chapter 11 case in which the secured creditors' collateral is sold, the secured creditor is undersecured, and there are

⁷⁰ See generally 11 U.S.C. §§ 1106, 1107 (2010).

insufficient funds to pay administrative claims, unless the secured creditor is surcharged or its security interest in proceeds is limited according to the “equities of the case” in order to make assets available to pay administrative claims that would otherwise be unpaid.

Granted, because the court will have to make an equitable determination and because the facts could be wide-ranging and complex, in some cases this factor could weigh in favor of an early settlement.

However, in many cases, garden-variety bankruptcy litigation is much more complex than surcharge litigation or “equities of the case” litigation might be. In an every-day preference action,⁷¹ for example, the estate could have to establish the real (as opposed to book) value of its assets and liabilities as an element of its cause of action. In response to defenses, it may have to develop facts regarding the timing of its ordinary payments. Similarly, in a fraudulent conveyance action, the estate may have to prove the value of the company at a specific time in the past, the cash flow of the company at a specific time in the past, the capital needs of the debtor at some time in the past, and perhaps the fair market value of assets transferred.⁷² These fact-intensive issues are much more complex than the facts involved in a § 506(c) or § 552(b) action. Accordingly, this factor does not support granting a § 506(c) or § 552(b) waiver.

C. The Expense, Inconvenience and Delay caused by the Litigation

Any litigation can be expensive, inconvenient, and time consuming. However, because the facts needed for the litigation are less complex than the facts in a great deal of other bankruptcy litigation, this factor should not weigh heavily in favor of a settlement of § 506(c) or § 552(b) issues at the outset of a case. Moreover, when an action to recover under sections §506(c) or § 552(b) is brought, the estate will typically have sold the bulk of its assets and be winding down. Accordingly, the litigation would not interfere with a reorganization of the debtor or distract management from its work in maximizing the value of the estate. For these reasons, this consideration does not support the estate granting a § 506(c) or § 552(b) waiver.

D. The Paramount Interest of Creditors and Deference

⁷¹ See 11 U.S.C. § 547 for elements of and defenses to a preference action.

⁷² See 11 U.S.C. § 548 for elements of and defenses to a fraudulent conveyance action brought under federal law.

to their Reasonable Views

This factor also does not weigh heavily in support of the § 506(c) and § 552(b) waivers because those waivers are oftentimes approved in a final order within the first month of a Chapter 11 case. At that point, many creditors will not really understand the likely outcome of the case. Are these waivers merely theoretical, or are they likely to be a pivotal factor in shaping the Chapter 11 case? Accordingly, although the creditors' opinions should be considered, the absence of an objection to any order containing these waivers should not be given much weight, especially when the papers filed do not really explain to creditors the possible practical impact of the waiver.

Another reason that this factor should not lean in favor of the waivers is that the very creditors who would be most affected by the waivers—administrative creditors who may not yet have provided goods or services to the estate—do not exist in many cases at the very beginning of the case when these waivers are entered into. Rather, by definition their claims arrive during the administration of the case.

But, you may reasonably think, a creditors' committee likely has been appointed⁷³ by the time the waivers are before the court, and committee counsel is typically extremely sophisticated in Chapter 11 practice. That is true, but this point is undermined, at least optically, by the fact that the documents providing for the § 506(c) waiver also generally provide for a carve out for committee counsel that protects committee counsel—but not other administrative creditors—from administrative insolvency. More importantly, Chapter 11 cases can be extremely complicated, and even the most sophisticated committee counsel is just beginning to familiarize itself with the case during the first month of a case.

There is, of course, the elephant in the room: the savvy secured creditor has provided its financing to the debtor or allowed for the use of its cash collateral with the caveat that it is a “take it or leave it deal” and if any of the questionable provisions in the financing or cash collateral order are not approved by the court, it will walk. The Court, Debtors' counsel, and committee counsel are understandably extremely concerned for the innocent persons who would be severely damaged if the case were to get underway without necessary funding. For example, the estate would have no cash to pay outstanding claims of workers. Managers could be liable for tax claims. Vendors would fear doing business with the debtor, and the business could collapse, costing people their jobs and

⁷³ 11 U.S.C. §§ 1102, 1103 (2016).

contracting counterparties, whose contracts might be assumed, their livelihoods or their businesses.

This is a valid concern and understandably professionals are driven to avoid an uncontrolled melt down and the carnage it could inflict on innocent parties. That being said, in many cases this fear amounts to the belief that the secured creditor's position is that it will shoot itself in the head if it has to pay for the benefits it obtains from a Chapter 11 case. Would secured creditors really want to walk away from the going concern value of an enterprise because it may have to pay the costs of keeping it afloat? A secured creditor that is a regular in Chapter 11 cases might walk away from the bargaining table once to bluff the bankruptcy bar into believing that it really will not finance a case without the 506(c) and 552 waivers, and that would be a terrible thing for the innocent parties, but the secured creditor might be reluctant to walk away a second time.

Despite the breadth of case law holding that the debtors may settle claims only if the above criteria support the settlement, courts do not undertake this analysis in approving the 506(c) or 552(b) waivers at the outset of a case. I submit that if they did, they would not approve the waivers in cases that started off with any real chance of being administratively insolvent or in which the reason for being of the case is to allow the secured creditor to liquidate its collateral expeditiously in a going concern sale.

But how is a court to know whether the case is designed to liquidate the collateral as a going concern? In many cases, that information should be easy to determine. The financing order will have a provision requiring the debtor to sell the collateral by a certain time. Therefore, the court will not have to guess about the secured party's intentions.

VI. A SECURED CREDITOR THAT SELLS ITS COLLATERAL IN A CHAPTER 11 GOING CONCERN SALE GENERALLY SHOULD BE SURCHARGED WHENEVER THE ESTATE IS ADMINISTRATIVELY INSOLVENT FOR THE COSTS OF THE ESTATE ADMINISTRATION

I suggest that the secured creditor should be surcharged the reasonable costs of administration. Those expenses are, for the most part, by their very definition necessary.⁷⁴ Many of them are, by definition,

⁷⁴ 11 U.S.C. § 503(b)(1)(A) (allowing as administrative expenses "actual,

reasonable.⁷⁵ When the case is filed to liquidate the secured creditors' collateral and not to confirm a reorganization plan, the case is, by definition, "for the benefit [of the holder] of the secured [claim]."⁷⁶

However, ultimately whether a case that is administratively insolvent is "for the benefit of the holder of the secured claim" also can be inferred from the actions of the secured creditor itself, because if it chooses not to bear those expenses, it can move to lift the automatic stay.

It is the automatic stay that binds a secured creditor to Chapter 11. Because of the automatic stay, a creditor cannot just take its collateral and foreclose under state law provisions. The court has to approve the creditor taking its collateral. But that approval should not be hard to obtain in an administratively insolvent case.

Code section 362(d) allows a secured creditor to lift the stay for cause. In the case of a creditor seeking to lift the stay to foreclose on property, the Code explains that cause includes the situation in which the property is not necessary for a reorganization and the debtor has no equity in the property.⁷⁷ In that case, the creditor has the right to a preliminary hearing in 30 days on its motion, and a final hearing on its motion in another 30 days.⁷⁸ The debtor has the burden of proving that the property is necessary to an effective reorganization, and the secured creditor, which should be expert in valuing collateral, has the burden of proving that the estate has no equity in the collateral.⁷⁹

Of course, any interpretation of the Bankruptcy Code that may impose additional costs on secured creditors can be attacked on the ground that the interpretation will discourage secured lending, dry up sources of capital, and depress the economy. This is an important issue, but it is difficult to prove whether a proposal designed to protect creditors rather than the secured lender will discourage secured lending. The benefit of the approach proposed herein, however, is that it allows

necessary costs and expenses of preserving the estate").

⁷⁵ 11 U.S.C. § 330(a)(1)(A) (providing that compensation must be "reasonable."); 11 U.S.C. § 503(b)(2) (incorporating reasonableness requirement of 11 U.S.C. § 330(a)(1)(A)); 11 U.S.C. §§ 503(b)(3)-5 (requiring expenditures be reasonable).

⁷⁶ *E.g.*, *In re Cascade Hydraulics & Utility Service, Inc.*, 815 F.2d 546, 548 (9th Cir. 1987); *In re Trim-X, Inc.*, 695 F.2d 296, 301 (7th Cir. 1982).

⁷⁷ 11 U.S.C. § 362(d)(2) (with respect to a request to lift the stay to foreclose on property, cause exists to grant the relief if "(A) the debtor does not have an equity in such property; and (B) the property is not necessary to an effective reorganization").

⁷⁸ 11 U.S.C. § 362(e) (2010).

⁷⁹ 11 U.S.C. § 362(g).

undersecured lenders to obtain the full benefit of their bargain—state law foreclosure—but choose themselves whether they think their recovery will be enhanced by using a federal liquidation remedy and bearing the costs of that remedy. Because secured lenders are in the business of assessing the value of their collateral, and, in truth, should not be making secured loans if they are not extremely competent in assessing the value of the collateral securing their loans, they should be well situated to make that decision expeditiously. They are in a better position than typical administrative creditors, who may be involuntary creditors or have no relation with one creditor, to determine whether the Chapter 11 case is worthwhile.

VII. CONCLUSION

The *LCI Holdings Case* discussed above created a roadmap for secured creditors to gain the benefits of Chapter 11 to liquidate their collateral, while at the same time walking away from the administrative expenses of Chapter 11. Paradoxically, secured creditors now can use our federal judicial procedure—admired throughout the world—to shortchange the United States of the very taxes that support that procedure. Because the license to use and abuse Chapter 11 is relatively new, we do not yet know all the ways in which legitimate administrative debts will be avoided in the future. But we do know that because the § 506(c) surcharge and § 552(b) “equity of the case” waivers are approved by the courts in the first month of many cases, the checks on abusive creditor action that Congress long ago inserted into the Code have been eviscerated. Courts should take a closer look at this DIP financing/cash collateral “boilerplate,” push back on these overreaching demands, and require secured creditors to *pay-to-play* if they want the benefits of Chapter 11.

The position set forth in this article is not radical. In its 2014-2015 ABI Commission to study the Reform of Chapter 11, the team of corporate lawyers leading the investigation concluded, albeit in a rather conclusory fashion, that “as with Section 506(c) and for similar reasons, the Commission voted to recommend that parties not be permitted” at the inception of a case⁸⁰ to provide for a 552 waiver. In the almost-thirty years since the 1978 Code went into effect, a lot has changed in the world of commercial lending. Banks like the Bailey Building and Loan Society increasingly seem pigeonholed into reruns of

⁸⁰ D.J. Baker, et al., *American Bankruptcy Institute Commission to Study the Reform of Chapter 11, 2012-2014*, 232-34 (AM. BANKR. INST 2014).

It's a Wonderful Life that show up in the weeks before Christmas. Provisions that Congress, after great study and debate included in the Code to balance the power of secured and unsecured lenders, are disregarded, with little analysis, driven perhaps by a visceral fear that if the lenders terms are not met, beneficial sales that might save jobs will be impossible. But a visceral fear that, if the law is followed, the Code will fail to serve its rehabilitative purpose, is an insufficient justification for disregarding the Code's plain language and the proof required to waive a valuable estate cause of action. Although this has been merely a preliminary discussion of the issues inspired by Professor Janger's⁸¹ discussion of the issues at the Akard lecture at the University of Texas, the importance of providing for a speedy waiver of an estate's rights to benefit from those provisions deserves greater descriptive, empirical, and normative attention.

⁸¹ Janger, *supra*, note 37.

