Articles + Publications | August 17, 2022

Texas Ruling Guides on Asset Sales for Secured Creditors

WRITTEN BY

Gary Marsh | Nathan T. DeLoatch

The general rule in bankruptcy is that administrative expenses, generally defined as the necessary costs and expenses of preserving property of the estate,[1] are paid from the debtor's bankruptcy estate.

However, Section 506(c) of the Bankruptcy Code provides an exception to this general rule, stating that

[t]he 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.[2]

Under this section, a party may charge a secured creditor with the administrative expenses associated with the secured creditor's collateral if three elements are satisfied:

1. The expenditures were necessary;

2. The amounts expended were reasonable; and

3. The secured creditor benefited from the expenses.[3]

According to the U.S. Bankruptcy Court for the Southern District of Florida's 2006 ruling in *In re: Hughes*, this is typically allowed "when [fees and expenses are] incurred primarily for the benefit of the secured creditor or when the secured creditor has caused or consented to the expense."[4]

The U.S. Court of Appeals for the Fifth Circuit's 1991 opinion in *In re: Delta Towers LTD* notes that the party seeking to surcharge the collateral for an expense bears the burden of proving that the expense was "incurred primarily for the benefit of … and … resulted in a quantifiable[,] direct benefit to the secured creditor."[5]

Interplay of Section 506(c) and Asset Sales Under Section 363

Many practitioners and secured creditors are familiar with Section 506(c) and its effects in the context of fees and

costs incurred in preserving or protecting the secured creditor's collateral — for example, through the maintenance of insurance.

But how might Section 506(c) relate to an asset sale under Section 363 or, more specifically, how might Section 506(c) apply when a secured creditor seeks to credit bid on its collateral in a bankruptcy sale?

A late June decision from the U.S. Bankruptcy Court for the Southern District of Texas answered this question, when it held that a secured creditor credit bidding in a Section 363 sale could be surcharged under Section 506(c) with a buyer's premium, to be paid in cash, so long as the surcharging party satisfies the elements of Section 506(c).

In *In re: Dalton Crane LC*,[6] the debtor engaged an auctioneer to sell all of the debtor's assets under Section 363.

First, the auctioneer attempted to sell the debtor's business as a going concern but was unsuccessful. Consequently, the auctioneer began to market and advertise the assets for public auction.

The proposed sale procedures provided that, among other things, a 7% buyer's premium would be charged to a purchaser of an asset paying in cash, while a 3% buyer's premium would be charged to a secured creditor that purchased an asset through credit bid.

Numerous secured creditors objected to the procedures, arguing that "they should be exempt from expenses since they intend[ed] to 'credit bid' at the [a]uction sale."[7]

In considering these objections, the court first noted that "[n]othing in [Section] 506(c) or the Fifth Circuit prevents a court from permitting a surcharge against the collateral of a successful credit bidder," so long as the requisite showing under Section 506(c) is made.[8]

The court also found guidance from the Fifth Circuit's 2009 decision in *In re: Skuna River Lumber*,[9] where the Fifth Circuit — while ultimately overturning on jurisdictional grounds the lower court's decision permitting a secured creditor to be charged with financial advisor's fees and expenses associated with an auction of the secured creditor's collateral — stated that the imposition of such fees and expenses would have been permissible had the bankruptcy court retained jurisdiction over the property.[10]

The court then considered certain objections raised by the secured creditors. First, the secured creditors argued that, by permitting a surcharge on credit bids, the court was effectively depriving them of the "indubitable equivalent" of their claims.

The requirement that a secured creditor receive the indubitable equivalent of its claim arises in the context of plan confirmation under Chapter 11 of the Bankruptcy Code.

Specifically, Section 1129(b)(2)(A) requires that a plan, in order to be fair and equitable, must meet one of the three following requirements:

1. The secured creditor retains a lien on its collateral and receives deferred cash payments;

2. The collateral is sold free and clear of the secured creditor's lien, subject to Section 363(k), and the creditor receives a lien on the proceeds of the sale; or

3. The creditor receives the indubitable equivalent of its claim.[11]

The court found this argument at odds with the U.S. Supreme Court's 2012 decision in *RadLAX Gateway Hotel LLC v. Amalgamated Bank*, where the Supreme Court held that debtors seeking to sell their property free and clear of liens under Section 1129(b)(2)(A) must only satisfy the requirements under clause 2, not the requirements of both clause 2 and 3.[12]

Thus, the court concluded that the indubitable equivalent clause did not come into play because the debtor satisfied clause 2 since it was pursuing a sale under Section 363 and permitting secured creditors to credit bid at the auction.

The secured creditors also argued that a surcharge could not be assessed because the Supreme Court in RadLAX stated that credit bidding "enables the creditor to purchase the collateral for what it considers the fair market price … without committing additional cash to protect the loan."[13]

The court, however, found little merit to this argument, simply finding that the additional cash that a successful credit bidder would pay to the auctioneer was not intended to protect the loan but to compensate the auctioneer under Section 506(c) for the costs of the sale.

The court ultimately held, as noted above, that a surcharge under Section 506(c) on a credit bid is permissible so long as the surcharging party can satisfy the elements of Section 506(c).

The Crane decision does not provide guidance as to what facts may lead a bankruptcy court to find that surcharging under Section 506(c) on a credit bid is appropriate, but case law addressing this question indicates that courts are likely to view the surcharging of a buyer's premium as appropriate because it is "in lieu of the costs a lender would incur to foreclose, market, and sell the property."[14]

In re: A-1 Plank & Scaffold Mfg. Inc.,[15] a 2011 decision relied upon by the court in Crane, is instructive on this point. In A-1, the court considered whether a broker was entitled to a commission based on the $800,000 cash bid even though a bank's much higher credit bid took the sale.

The debtor engaged a broker to sell certain pieces of its real property and entered into a sales agreement that, among other things, entitled the broker to a sales commission based on "any sale or exchange of the [p]roperty which closes."

The marketing of the property generated two competing bids — an $800,000 cash offer from a third party and a $1.75 million credit bid from the bank whose collateral was the property being sold. The bank objected to the payment of any commission to the broker, arguing that it should not be liable for any commission because its

credit bid took the sale.

The court found that the question implicated both state and bankruptcy law. Generally, under Kansas law, a broker may still be entitled to receive a commission if the failure to close arises from circumstances beyond its control and the broker produces a buyer that is ready, willing and able to close; and is efficient in procuring such a buyer.[16]

The court also noted that the debtor and broker had contracted for the payment of commission on "any sale or exchange of the [p]roperty which closes," and that this agreement was valid under Kansas law.[17] Thus, the court concluded that the broker had satisfied the requirements under applicable state law to be entitled to receive commission.

The court then considered the application of bankruptcy law, specifically whether the broker provided the bank with a benefit sufficient to satisfy the requirements of Section 506(c). In considering the facts before it, the court found that the broker provided a benefit to the bank in two specific ways.

First, the broker marketed the property and procured a prospective cash purchaser and, by doing so, established market value for the property. The court found that this was not negated by the fact that the bank's credit bid was more than twice the procured cash offer.

The court chose not to penalize the broker for the bank's decision to credit bid, explaining that the broker "undertook the engagement and sought buyers without knowing the extent to which the [b]ank intended to expend its claim or that it was a certainty that the [b]ank would thwart any cash deal[,]" and noting further that "[o]ften lenders are only too happy to get cash."[18]

The court also found that the bank received a benefit due to the bank's ability to leverage its credit bid to exact a higher cash offer from the third party.

The court noted that the broker, by bringing the third party to the negotiating table, created the opportunity for the bank and the third party to negotiate directly with one another, resulting in a higher cash offer for the property and the creation of side deals between the bank and third party concerning other real property being sold by the debtor.

The court found that, through these deals, the bank was able to avoid the costs and expenses of marketing and selling property itself. The court also found that there was sufficient case law in support of the holding that an estate professional cannot be denied compensation simply because of a secured creditor's use of a credit bid.[19]

As a result, the court held that:

- The broker was entitled to the 6% commission on the $800,000 cash offer;
- A surcharge of that amount would be assessed against the property prior to its conveyance to the bank; and
- That the bank had to pay that amount to the broker in cash to close the sale.

Conclusion and Takeaways

To address the impact Section 506(c) may have on asset sales in bankruptcy and to limit potential exposure to a surcharge under Section 506(c), secured creditors seeking to credit bid in such sales should consider, among other things, the following practices.

Secured creditors should carefully review proposed agreements seeking to employ professionals and related agreements setting forth procedures for a proposed sale. If a secured creditor intends to credit bid, it should consider objecting to any provision, providing a professional the right to surcharge in the event of a credit bid.

Notwithstanding the fact that the failure to object prior to approval of such provisions likely results in a waiver of its right to do so later, the secured creditor should object early — prior to any work being done by the professional — to cut off any argument that the secured creditor received a benefit from the professional's work.[20]

Also in the context of retention applications or a sales procedures order, a secured creditor may seek to include provisions, therein giving it the right to review any proposed expenditures in advance, that may be surcharged against its collateral.

Alternatively, and if reasonable under the given circumstances, the secured creditor may outright request that certain services be omitted.

In the context of a cash collateral or debtor-in-possession financing order,[21] a secured creditor should seek to include a Section 506(c) waiver, whereby the debtor, or trustee, waives its right to surcharge the secured creditor's collateral.

They should also seek relief from the automatic stay to ensure that the secured creditor can foreclose on its collateral under applicable state law and exercise its right to credit bid in that foreclosure proceeding without the risk of surcharge.

---

[1] See 11 U.S.C. § 503(b)(1)(A).

[2] 11 U.S.C. § 506(c).

[3] *In re Matter of Delta Towers, Ltd.*, 924 F.2d 74, 76 (5th Cir. 1991) (citations omitted).

[4] *In re Hughes*, 2006 WL 130867, at *2 (S.D. Fla. 2006).

[5] *In re Matter of Delta Towers, Ltd.*, 924 F.2d at 76 (citations omitted).

[6] *In re: Dalton Crane LC*, 2022 Bankr. LEXIS 1813 (Bankr. S.D. Tex. June 29, 2022).

[7] See id. at *21.

[8] Id. at *22.

[9] *In re Skuna River Lumber, LLC*, 564 F.3d 353 (5th Cir. 2009).

[10] Id. at 356.

[11] 11 U.S.C. § 1129(b)(2)(A).

[12] See *RadLAX Gateway Hotel, LLC v. Amalgated Bank*, 566 U.S. 639, 643 (2012).

[13] Id. at 644 n.2 (emphasis added).

[14] *In re NJ Affordable Homes Corp.*, 2006 WL 2128624 at *16 (Bankr.D.N.J.2006). See *In re A-1 Plank & Scaffold Mfg., Inc*., 437 B.R. 689, 695 (Bankr. D. Kan. 2010) (citing cases).

[15] 437 B.R. 689 (Bankr. D. Kan. 2010).

[16] Id. at 693-94.

[17] Id.

[18] Id. at 695.

[19] Id. at 695.

[20] A secured creditor should also pay close attention to any provision regarding the extent to which the bankruptcy court retains jurisdiction over the property following the sale because there exists authority holding that, once property is transferred out of the estate free and clear of all liens, the property can no longer be surcharged under Section 506(c). See *In re Skuna River Lumber, LLC*, 564 F.3d 353, 355 (5th Cir. 2009) (“when property is transferred out of a bankruptcy estate free and clear of all liens, the bankruptcy court ceases to have jurisdiction over that property… and therefore [the property] may not be surcharged under section 506(c).”)

[21] This is significant because only a trustee or debtor-in-possession has an independent right to invoke Section 506(c). See *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000). However, it must be noted that the Supreme Court declined to address whether interested parties have derivative standing to pursue recovery under Section 506(c) should a trustee or debtor-in-possession unjustifiably refuse to do so. See id. at 13 n.1. As such, the question of standing may depend upon where the case is pending, among other factors. Compare *Debbie Reynolds Resorts, Inc. v. Calstar Corp., Inc. (In re Debbie Reynolds Hotel & Casino, Inc.)*, 255 F.3d 1061, 1065-66 (9th Cir. 2001) (precluding derivative actions under Section 506(c)) and *In re Smith Int’l Enters.*, 325 B.R. 450, 454-56 (Bankr. M.D. Fla. 2005) (same), with *Hyundai Translead, Inc. v. Jackson Truck & Trailer Repair, Inc. (In re Trailer Source, Inc.)*, 555 F.3d 231, 245 (6th Cir. 2009) and *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex. rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 568-69 (3d Cir. 2003)

(finding, in the context of avoidance actions, that Hartford Underwriters does not preclude bankruptcy courts from granting derivative standing to creditors seeking to pursue those actions on behalf of the estate).

RELATED INDUSTRIES + PRACTICES

- Bankruptcy + Restructuring