Direct Lenders Beware: How Your World Can Turn Upside Down in Chapter 11

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You are a first or second lien lender. Your borrower (now a debtor) files bankruptcy, and seeks to use proceeds of your collateral (cash collateral) to fund the case. You agree to a budget, but later the debtor seeks to surcharge your collateral for additional costs, which the debtor asserts total tens of millions of dollars, on the grounds that it incurred them to preserve and maintain your collateral. In other words, the debtor wants you to foot the bill. This is essentially what happened in the Sears Chapter 11 case, and highlights the risks to creditors if they do not get it right. Direct lenders should pay close attention.

Absent an express agreement to the contrary, the expenses associated with a bankruptcy case do not get paid from collateral proceeds, but rather unencumbered assets. However, there is an exception to this general rule: if the debtor uses unencumbered cash to maintain or sell encumbered assets, it can seek to “surcharge” the secured creditor under section 506(c) of the Bankruptcy Code.

To avoid this outcome, a secured creditor should demand that a debtor waive the estate’s right to seek a surcharge under section 506(c) in exchange for its agreement to allow the debtor to use cash collateral and/or to provide DIP financing. Although a secured creditor typically obtains a 506(c) waiver in a cash collateral and/or DIP financing order, lenders of all types, including bulge-bracket commercial and investment banks, private credit lenders, BDCs, hedge funds and CLOs, should understand the potential for litigation if they proceed without one.

Recently, Sears sought to surcharge its second lien lenders with more than $1.4 billion of expenses incurred in connection with a disposition of collateral in its high-profile bankruptcy case. After the second lien lenders asserted a roughly $200 million superpriority claim for alleged diminution in the value of their collateral pursuant to section 507(b) of the Bankruptcy Code, Sears countered with its $1.4 billion surcharge under 506(c) to establish that the second lien lenders were not entitled to anything. Judge Drain ultimately denied surcharge, but the decision still serves as a reminder to secured creditors of the importance of 506(c).[1]

Section 506(c)

Bankruptcy Code section 506(c) authorizes a debtor that used unencumbered cash to pay expenses to preserve or benefit collateral, to recover those expenses from the secured creditor upon satisfaction of three conditions (other than through express consent): (i) the expenses must be "necessary" to preserve or dispose of the collateral, (ii) they must be "reasonable," and (iii) the incurrence of the expenses must provide a "benefit" to the secured creditor. In doing so, Bankruptcy Code section 506(c) facilitates the equity policy of chapter 11 by preventing a windfall to a secured creditor that would result if the debtor and unsecured claimholders were forced to pay costs that benefit the secured creditor alone.

Sears Dispute

In Sears, the debtors attempted to surcharge second lien lenders with more than $1.4 billion of administrative expenses. After extensive briefing and a trial with dueling expert testimony, Judge Drain denied Sears' motion, which sought to value at zero claims asserted pursuant to Bankruptcy Code section 507(b) for diminution in the value of second lien collateral on the basis that the amount of costs required by the 506(c) surcharge would far exceed any alleged diminution amounts. See Hr'g Tr. 250:13, *In re Sears Holdings Corp.*, Case No. 18-23538 (Bankr. S.D.N.Y. July 31, 2019).

Practical Observations

While the size of the attempted surcharge is notable, the ruling warrants careful attention for three reasons. First, the debtors and the statutory creditors' committee did not support a 506(c) waiver at the outset of the case due to the fact that ESL, Sears' controlling equity holder, owned more than 70% of the second lien debt and had been the target of potential causes of action the estate may have determined to prosecute later. Thus, the second lien lenders agreed to the use of cash collateral without procuring a surcharge waiver. Second, like many retailers in chapter 11 today, even with a going concern sale, Sears faced more than just a theoretical prospect of administrative insolvency. As a result, when the estate lacks sufficient cash to pay administrative claims, the debtor may view section 506(c) as a potential source to fund an administrative expense shortfall. Finally, unlike the typical case where the estate is administratively insolvent and the debtor must try to procure money to pay its administrative claims, Sears deployed 506(c) as a weapon to offset the adequate protection claims of the second lien lenders in an unprecedented amount.

After consideration of these unique factors, Judge Drain ruled that the second lien lenders must cap any 507(b) claims at the amount they agreed upon in the asset purchase agreement that effectuated the disposition of collateral and estimated those claims at zero. In doing so, Judge Drain also denied the debtors' request for a 506(c) surcharge.

The decision provides a stark reminder to secured creditors of the importance of insisting upon a 506(c) waiver when they have the opportunity to do so. Without one, secured creditors may face protracted and costly litigation, and potentially a surcharge against their collateral. Secured creditors also should be aware, however, that section 506(c) waivers may not provide a complete solution. While such an arrangement prevents the estate from imposing a surcharge, it does not always mean the secured creditors will receive the benefit of unencumbered cash. The debtor can sometimes use the secured creditor's own cash collateral (and not unencumbered cash) to maintain or sell its collateral, and the debtor retains the option not to use unencumbered cash to benefit the collateral unless the secured creditor later agrees to reimburse the debtor.

[1] The second lien lenders since have filed an appeal of Judge Drain's ruling solely as it relates to the 507(b) claim estimation, not the 506(c) surcharge issue.

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