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David Gray Carlson

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SECURED CREDITORS AND EXPENSES OF BANKRUPTCY ADMINISTRATION

DAVID GRAY CARLSON*

In any complex bankruptcy proceeding one of the most poignant questions facing the parties and the court is who must pay the trustee's expenses. In addition to routine administrative costs, such expenses may include costs of disposing of estate assets, or, in reorganization proceedings, expenses necessary to preserve the assets and going-concern value of the debtor's business. In this Article, Professor David Gray Carlson undertakes a comprehensive examination of the law of bankruptcy expense allocation through the lens of Bankruptcy Code section 506(c), the trustee's principle tool for charging expenses to secured creditors. After a careful examination of priority and collateral valuation issues under section 506(c), Professor Carlson suggests a rule for Chapter 11 reorganizations by which expenses properly allocable to secured creditors can be distinguished from ordinary expenses of reorganization traditionally borne by unsecured parties. Specifically, he suggests that secured creditors whose liens encumber a debtor's entire cash flow should bear any costs in excess of debtor equity associated with preserving that income. Among secured parties whose liens do not reach cash flow, Professor Carlson suggests charging only that portion of maintenance expense that does not exceed a proper valuation of the secured party's collateral. The Article concludes by testing the proposed rule against holdings in several bankruptcy cases.

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Against the secured creditor's right to adequate protection in bankruptcy¹ stands its lesser known mirror opposite—the trustee's right under Bankruptcy Code section 506(c)² to charge the secured creditor for expenses of preserving or disposing of the collateral. The two are mirror opposites in this sense: Adequate protection prohibits, while section 506(c) invites, the reduction of the secured creditor's entitlements in bankruptcy.

Left unguarded, section 506(c) threatens to swallow adequate protection whole. It is a breach in the front lines of adequate protection through which ordinary administrative expenses may pour.

On the other hand, section 506(c) is an admirable weapon against an insidious tendency in state law to permit the creation of great floating liens that soak up all conceivable assets of the debtor, leaving nothing in the bankrupt estate for general creditors or even for administrative costs. The floating lien has unquestionably accelerated the phenomenon of the assetless bankruptcy. These liens go so far as to encumber the income streams of businesses, so that even incoming cash belongs to the secured creditors. Section 506(c) combats the pervasive floating lien by permitting the trustee to charge the secured creditor for services rendered—charges that state law would not permit.³ Section 506(c) may be defended, then, as a partial undoing of the unduly powerful rights given to secured parties by state law—a remedy that is necessary if bankruptcy

1. Section 363(e) of the United States Bankruptcy Code provides:

Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide *adequate protection* of such interest.

11 U.S.C. § 363(e) (1988) (emphasis added). Adequate protection was introduced or at least substantially transformed by the Bankruptcy Reform Act of 1978. For a history of pre-Code adequate protection, see David Gray Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 581-90 (1989).

2. 11 U.S.C. § 506(c) (1988). Section 506(c) 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." *Id.*

3. For example, under § 506(c) a secured creditor can be made to contribute to the operation of a business. *In re AFCO Enters., Inc.*, 35 B.R. 512, 514-15 (Bankr. D. Utah 1983) (Clark, J.) (secured creditor made to finance upkeep of resort hotel). Article 9 of the Uniform Commercial Code, on the other hand, provides that a secured creditor simply may take the collateral without contributing anything to its upkeep, even though this cost is exported to the general creditors of the debtor. See U.C.C. § 9-504(1) (1972).

Sometimes real estate law requires that, where a mortgagee claims rental income, the first charge upon that income is upkeep of the property. See, e.g., *In re Brandon Assocs.*, 128 B.R. 729, 733-34 (Bankr. W.D. Va. 1991) (Krumm, J.) (describing Virginia law); *In re Coniam*, 9 B.R. 306, 309 (Bankr. D. Conn. 1981) (Krechevsky, J.) (describing Connecticut law).

trustees are to be paid.⁴

A mediating principle is therefore necessary to make clear when the bankruptcy trustee may legitimately charge the secured creditor with expenses and when such charges must be rejected as illicit attempts to shift the expenses of unsecured creditors onto secured creditors. Currently, courts resort to slogans that admonish trustees to charge the secured creditor only when the secured creditor is "directly" or "primarily" benefited by the expense.⁵ Such slogans simply repeat the question; instead, what is "primary" or "direct" must be made explicit by a theory of section 506(c)'s scope and purpose.

This Article suggests a theory whereby the ordinary expenses of a reorganization may be distinguished from expenses properly borne by the secured creditor. According to this theory, if the security interest is a "floating lien" that encumbers the entire bankrupt estate, including the cash flow of a going concern, courts should freely charge the secured creditor with the expenses relevant to maintaining the cash flow. But if the security interest does not reach the cash flow, then courts should not charge the secured creditors with all the expenses of maintaining the income. Instead, the court should charge some lesser amount depending on how it values the collateral involved: if the court values the collateral according to a liquidation standard, nothing should be charged. If, on the other hand, the court uses a "going-concern" value for the collateral, it should charge a portion of the maintenance expense. The amount under the going-concern standard can be determined by imagining what would have happened if the automatic stay had been lifted and the secured creditor had repossessed. Any of the administrative expenses that would have been incurred by the secured creditor between the lifting of the stay and the selling of the property should be charged to the secured creditor.

Two preliminary questions must be answered before this theory can be fully explored. The first goes to the exact priority of the trustee's claim against the collateral under section 506(c). Surprisingly, this topic has received almost no attention in the literature, perhaps on the mistaken assumption that the priority is well understood. An examination of the cases shows that the courts are deeply divided on the priority question. For example, trustees have succeeded in setting off section 506(c)

4. See S. REP. NO. 989, 95th Cong., 2d Sess. 40 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5826 (declaring policy to encourage members of the bar to render the necessary and exacting services that bankruptcy requires); H.R. REP. NO. 595, 95th Cong., 1st Sess. 330 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6286 (declaring policy of encouraging bankruptcy specialists to remain in the field).

5. See *infra* text accompanying notes 202-16.

expenses against the secured creditor's entitlement to postpetition interest and collection expenses under section 506(b).⁶ This setoff imposes expenses on secured creditors that should properly be borne by the trustee. Alternatively, courts have approved schemes whereby the secured creditor shares section 506(c) expenses pro rata with junior secured creditors or with the trustee.⁷ This likewise imposes on secured creditors expenses they should not bear. These abuses would disappear if the exact priority of section 506(c) expenses were understood. Part I of this Article examines the question of priority, including such issues as the standing of creditors other than the trustee to sue the secured creditor under section 506(c); the in personam nature of this right to sue; and the effect of a section 506(c) charge on the unsecured deficit claim of a secured creditor.⁸

Part I also considers whether secured creditors could be charged with the ordinary expenses of bankruptcy administration without the aid of section 506(c). One device is section 552(b),⁹ which, according to the legislative history, allows a trustee to disencumber a secured creditor's right to cash proceeds if the equities demand. The legislative history expressly mentions "expenditures by the estate relating to the proceeds."¹⁰ It is unclear, however whether this idea adds anything not already implicit in section 506(c). Another such theory states that lawyers and other professionals may be paid on an interim basis under section 331 of the Bankruptcy Code. If such payments are made and adequate protection of security interests later fails, the secured creditors bear the cost of the trustee's professional advice because payment to the professionals under section 331 is final and need not be returned. The weight of authority is certainly against this theory,¹¹ although courts must be careful in disposing of the lawyers not to endanger ordinary course transactions, which also rely on interim payments that are junior to secured creditor rights. Finally, Part I discusses attempts to shift expenses to secured creditors in cases involving the pledge of unencumbered assets to a postpetition lender who agrees to pay the trustee and her lawyers directly. These "carve-out" orders are designed to make sure that the loan proceeds never enter the bankrupt estate. Thus, if a secured creditor's adequate protection fails, unencumbered assets that ought to compensate

6. 11 U.S.C. § 506(b) (1988); see *infra* notes 21-24 and accompanying text.

7. See *infra* notes 25-26 and accompanying text.

8. As will be seen, a § 506(c) charge necessarily implies that a creditor is undersecured. See *infra* text accompanying notes 12-39.

9. 11 U.S.C. § 552(b) (1988).

10. 124 CONG. REC. 32,400 (1978) (statement of Rep. Edwards).

11. See *infra* notes 109-14 and accompanying text.

the secured creditors have been funneled to the trustee's lawyers instead. Like the argument that professional payments under section 331 are final, this theory is designed to ensure that, when adequate protection of a security interest fails, the lawyers may nevertheless keep their fees, even though they are junior to the rights of secured creditors. If this occurs, the secured creditors have borne the expenses of bankruptcy administration when section 506(c) demands that the secured creditors be held harmless.

A second matter to be addressed is the relationship between the scope of section 506(c) and the valuation theory a court uses with regard to collateral. Under many theories of value, collateral is assessed by imagining the amount a buyer would pay for collateral, reduced by the expected costs of the transaction, so that the measure of the collateral becomes what the secured creditor would realize from the sale. Yet section 506(c) allows the trustee to extract the same transaction costs from the secured creditor that are deducted in such a valuation theory. Consequently, the secured creditor effectively pays twice for the same transaction. Part II of this Article describes the relationship between (1) *expected* transaction costs on the amount of a secured claim in bankruptcy, and (2) the *actual* transaction costs the trustee wants to recover under section 506(c). Part II shows that, if an allowed secured claim is reduced by the amount of expected transaction costs, certain substantive rules on the allocation of *actual* expenses to the secured creditor must follow. That is, a bankruptcy court's theory of value will of necessity influence the trustee's substantive right to charge expenses under section 506(c).

Part III argues for a theory that separates the ordinary expenses of administration from expenses properly allocated to a secured creditor. Such a theory is especially important in reorganization cases, where the collateral might never be sold. The theory demands answers to two key factual questions. First, is the secured creditor oversecured? If so, the equity cushion may be freely invaded to finance any legitimate expense of the trustee, so long as the secured claim is otherwise adequately protected. Second, who owns the cash flow? If a floating lien comprehends all income, the secured creditor should pay ordinary administrative expenses. If the cash flow is unencumbered, the bankrupt estate should pay, except that the trustee may retain any administrative expenses that the secured creditor would have incurred had there been no bankruptcy. These rules will better determine whether the secured creditor or the bankrupt estate should bear the costs of administration in a reorganization.

I. THE TRUSTEE'S RIGHTS UNDER SECTION 506(C)

A. Priority

It is a universal rule of debtor-creditor law that the highest priority to proceeds from a foreclosure sale goes to reimburse the enforcement officer who conducted the sale.¹² Without this priority, no independent enforcement officer would proceed. The Bankruptcy Code follows this rule in section 506(c), which permits a bankruptcy trustee to collect sales and preservation expenses from the collateral.¹³ Although section 506(c) does not say this directly, it clearly implies as much: "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."¹⁴ This provision necessarily means that the trustee or her subrogees may invade an allowed secured claim¹⁵—provided, of course, that the expenses are reasonable, necessary, and to the benefit of the secured creditor. The statute must confer on the trustee the power to invade the secured claim because the trustee already has the right to invade debtor equity, which is, after all, property of the estate.¹⁶

12. See, e.g., U.C.C. § 9-504(1)(a) (1972).

13. The legislative history claims this codifies pre-Code law. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 357 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6313; S. REP. NO. 989, 95th Cong., 2d Sess. 68 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5854. For history of pre-Code law, see Leigh H. Savage, *The Secured Claimholder's Liability for the Costs and Expenses Incurred in Bankruptcy*, 90 COM. L.J. 430, 434-40 (1985); J. Hobson Presley, Jr., Note, *The Cost of Realization by the Secured Creditor in Bankruptcy*, 28 VAND. L. REV. 1091, 1092-93 (1975) [hereinafter Presley, Note].

Judge Johnson recently expressed the view that § 506(c) is a codification of the "common fund" doctrine. *New Orleans Pub. Serv., Inc. v. First Fed. Sav. & Loan Ass'n (In re Delta Towers, Ltd.)*, 924 F.2d 74, 78-79 (5th Cir. 1991). According to this doctrine, admiralty lien creditors must pay the expenses necessary to preserve property *in custodia legis*. See *New York Dock Co. v. The S.S. Poznan*, 274 U.S. 117, 121 (1927) (Stone, J.). As to whether § 506(c) has preempted the "common fund" doctrine, Judge Johnson thought that only "exceptional circumstances" justified using it in cases where § 506(c) barred recovery. *First Fed.*, 924 F.2d at 79. As an example of "exceptional circumstances," Johnson cited *Fanelli v. Hensley (In re Triangle Chemicals, Inc.)*, 697 F.2d 1280 (5th Cir. 1983), in which Judge Tate ruled that the equitable doctrine justified compensating an attorney whose employment was not approved in advance by the bankruptcy court, as Bankruptcy Code § 327(a) requires. *Id.* at 1289. *Fanelli* was not, however, a case in which secured creditors were made to pay. See *id.* at 1282. Rather, the general creditors paid the attorney's fee on the theory that the bankrupt estate was enhanced in value. *Id.*

14. 11 U.S.C. § 506(c) (1988).

15. See *In re Trim-X, Inc.*, 695 F.2d 296, 298-99 (7th Cir. 1982) (Swygert, J.) (reversing district court ruling that § 506(c) expenses may only be taken out of debtor equity); *In re AFCO Enters., Inc.*, 35 B.R. 512, 514 (Bankr. D. Utah 1983) (Clark, J.) (allowing invasion of secured claim).

16. See 11 U.S.C. § 364(c)(3) (1988) (after notice and hearing, trustee may obtain credit by placing a junior lien on collateral).

For example, assume a creditor owns an allowed secured claim of \$90 on collateral that the trustee sells for \$100. Assume also that the trustee has incurred \$8 of reasonable and necessary sales expense. Of the \$100, \$10 is debtor equity and already property of the bankrupt estate. Here, the trustee does not need section 506(c) to recover the \$8 sales expense. It can be taken out of the debtor equity.¹⁷ If section 506(c) is unneeded on these facts, then it must exist for the sole purpose of allowing the trustee to invade the secured claim. Thus, if the trustee's expenses were \$12, it is necessary for the trustee to invade the secured claim for \$2. This is precisely what section 506(c) permits.

Trustees take special delight in imposing section 506(c) expenses on the secured creditor without touching the debtor equity. For example, the trustee with the \$8 expense and \$10 in debtor equity will sometimes try to reduce the secured creditor's claim from \$90 to \$82 (or try to get straight reimbursement from the secured creditor, which is the same thing). If the trustee succeeds, the estate is enriched—the maneuver preserves an asset of the bankrupt estate and foists some costs on the secured creditor. To be sure, if the secured creditor's secured claim is reduced by these charges, the secured creditor is compensated with a larger countervailing unsecured claim.¹⁸ But the secured claim is paid out 100 cents on the dollar; the unsecured claim is usually paid out for far less. Therefore, the estate benefits if the trustee can take administrative expenses out of the secured claim, rather than out of the debtor equity which already belongs to the estate.

On its face, section 506(c) sanctions the recovery of expenses "from property securing an allowed secured claim."¹⁹ This language allows for access to debtor equity, but it does not permit the invasion of a secured claim unless the trustee's 506(c) claim and the secured creditor's claim against the property are, in combination, greater than the value of the collateral. Only when the two claims overwhelm the value of the collateral—when the debtor equity is exhausted—does section 506(c) sanction the invasion of the secured claim.

Courts usually protect the secured creditor from invasions of the secured claim before the debtor equity is exhausted, although they fre-

17. The \$8 expense would be an administrative expense under Bankruptcy Code § 503(b). See *Id.* § 503(b). The trustee would have an administrative priority for this expense under § 507(a), *id.* § 507(a), which will be vindicated in distributions under Chapter 7 in § 726(a), *id.* § 726(a), or in Chapter 11 reorganizations under § 1129(a)(9)(A), *id.* § 1129(a)(9)(A). See also *id.* §§ 1226(b)(1), 1326(b)(1) (requiring administrative claimants to be paid in cash before other creditors in family farm or wage plans).

18. *Id.* § 506(a). The basis for this claim is discussed *infra* in the text accompanying notes 66-79.

19. 11 U.S.C. § 506(c).

quently do so in confusing terminology. It is common in such cases for the court to say that the expenses produced no "benefit" for the secured creditor, as section 506(c) requires.²⁰ It would be clearer if the courts simply said that the expenses must first come out of debtor equity.

A second way trustees try to accomplish their illegitimate goal of raiding the secured claim before the equity is exhausted is by trying to set off section 506(c) expenses against section 506(b) entitlements to postpetition interest and collection expenses²¹ at a time when unencumbered equity still exists.²² Setoff cases can be unfair when the debtor equity is valuable enough that the secured creditor would never bear the 506(c) expenses.²³

Suppose, again, that the secured creditor's claim is \$90 and the collateral is worth \$100. Suppose further that, under section 506(b), the

20. See, e.g., *Schindler v. Sharak (In re Salzman)*, 83 B.R. 233, 240-41 (Bankr. S.D.N.Y. 1988) (Schwartzberg, J.); *In re West Post Rd. Properties Corp.*, 44 B.R. 244, 247 (Bankr. S.D.N.Y. 1984) (Schwartzberg, J.); *Federal Land Bank v. Belew (In re Belew)*, 44 B.R. 12, 13-14 (Bankr. N.D. Ala. 1984) (Brelend, J.); see also *In re Creed Bros.*, 70 B.R. 583, 587 (Bankr. S.D.N.Y. 1987) (Schwartzberg, J.) (interpreting the Bankruptcy Act of 1898).

21. An equity cushion implies that a secured creditor is oversecured and hence entitled to receive postpetition interest and collection expenses under Bankruptcy Code § 506(b). Section 506(b) provides:

To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

11 U.S.C. § 506(b) (1988). Of course, if there is no debtor equity, the secured claim consists of any prepetition amounts claimed plus any § 506(b) interest and collection expenses already accrued. David Gray Carlson, *Oversecured Creditors Under Bankruptcy Code Section 506(b): The Limits of Postpetition Interest, Attorneys' Fees, and Collection Expenses*, 7 BANKR. DEV. J. 381, 389-91 (1990) (describing how accruing postpetition interest increases the size of the secured claim). In such a case, § 506(c) justifies invading the secured claim and, with it, any accrued 506(b) entitlements. *In re Chateau Royale, Ltd.*, 6 B.R. 8, 13 (Bankr. N.D. Fla. 1980) (Sauls, J.).

22. *Crownover v. Manufacturers Hanover Commercial Corp. (In re Central Foundry Co.)*, 45 B.R. 395, 407-08 (Bankr. N.D. Ala. 1984) (Wright, J.). A setoff was not demanded in *Central Foundry*, but it is clear it was awarded. See *id.* Nevertheless, the secured creditor was oversecured and entitled to postpetition interest. *Id.* The invasion of the secured claim under these conditions amounts to the same as a setoff. See *In re Elmwood Farm, Inc.*, 19 B.R. 338, 340-41 (Bankr. S.D.N.Y. 1982) (Schwartzberg, J.) (trustee allowed to invade secured claims while secured parties oversecured and entitled to postpetition interest); *Chateau Royale*, 6 B.R. at 13 (setoff allowed, but not clear that creditor oversecured at time of setoff).

23. There is a theory that would allow the setoff and the priority that § 506(c) demands. According to this theory, entitlements under § 506(b) do not lock in until the estate is distributed or the Chapter 11 plan is confirmed. See *McCombs Properties VI, Ltd. v. First Tex. Sav. Ass'n (In re McCombs Properties VI, Ltd.)*, 88 B.R. 261, 266 (Bankr. C.D. Cal. 1988) (Ryan, J.); *In re National Computer Communications Corp.*, 85 B.R. 6, 7 (Bankr. D. Conn. 1988) (Schiff, J.); Niall L. O'Toole, *Adequate Protection and Postpetition Interest in Chapter 11 Proceedings*, 56 AM. BANKR. L.J. 251, 262-74 (1982). Curiously, this view of § 506(b) entitle-

secured creditor is entitled to claim another \$5 for postpetition interest and collection expenses and that the trustee's enforcement expenses are \$4. If the collateral is liquidated, the secured creditor ought to get \$95, the trustee should get \$4 in section 506(c) expenses, and the estate should receive \$1. If the trustee is allowed to set off the \$4 in section 506(c) expenses against the secured creditor's 506(b) expenses, then the secured creditor gets only \$91, while the trustee gets \$4 in expenses, and the estate takes \$5. This seems unfair; section 506(c) authorizes payment of the \$4 in expenses from the collateral, but it does not permit the invasion of the secured claim until the debtor equity is exhausted.²⁴ Under the setoff rule, oversecured creditors are made to bear these expenses, to the benefit of general unsecured creditors.

Equally unacceptable are holdings that require secured parties to share a pro rata burden of expenses, even though the equity cushion has not been depleted, or even though one secured creditor has priority over the other.²⁵ A senior secured creditor should bear *no* part of 506(c) expenses until debtor equity is exhausted. To put it another way, a senior secured creditor is entitled to a sort of "absolute priority rule" whereby her claim may not be invaded if the bankrupt estate or a junior secured creditor receives any recovery at all. On the other hand, where two secured parties claim two separate pieces of collateral, and the transfer incurs a joint expense for the sale of both, proration is appropriate. In this

ments most closely resembles the state of the law under the old Bankruptcy Act. See Carlson, *supra* note 1, at 590-96.

Under this view of § 506(b), the trustee is *always* free to invade the secured claim (to the extent of postpetition interest or collection expenses, but not further) simply because the secured creditor is not entitled to adequate protection of this part of the secured claim.

24. The state-law result is similar. See U.C.C. § 9-504(1)(a) (1972) (implying that such expenses are a charge against collateral independent of the secured creditor's senior claim, so that debtor equity picks up these costs when such equity exists).

25. *Central Foundry*, 45 B.R. at 407; *Elmwood Farm*, 19 B.R. at 342. According to one author:

When courts have referred to the proportionate share of expenses to be borne by the secured creditor they apparently assume that the benefit derived by the secured creditor from the sale is equivalent to the amount of secured credit over the value of the security. Thus, if the secured debt is 9/10 of the value of the secured asset, the creditor would realize 9/10 of the benefit of the sale and should pay 9/10 of the attendant costs.

Presley, Note, *supra* note 13, at 1099 n.38. Using the example in the text, suppose a buyer would pay \$100 for collateral, and a secured creditor claims \$90 before transaction costs. The Note author suggests that the general creditors bear 1/10 of the cost for the secured creditor—a subsidy because the debtor would have borne 100 percent of the expense had there been no bankruptcy. *Id.*

Sometimes a secured creditor *consents* to pro rata sharing. Such agreements are enforceable. See *Federal Land Bank v. Belew (In re Belew)*, 44 B.R. 12, 13-14 (Bankr. N.D. Ala. 1984) (Breland, J.).

context, no secured creditor's seniority is being compromised for the benefit of some junior claimant.²⁶

This is not to say that section 506(c) expenses are subordinate to secured claims. It should be understood that section 506(c) is a superpriority.²⁷ Thus, in the above example, of the \$100 in cash proceeds obtained by the trustee, the trustee's \$4 expense has first priority, the secured creditor's \$95 comes second, and the remaining \$1 is debtor equity that goes to the bankrupt estate. In other words, the 506(c) expense takes priority over the secured claim it invades, but the secured claim itself is not reduced until the debtor equity has disappeared.²⁸

The requirement that debtor equity be exhausted before the trustee can invade the secured claim raises another very difficult issue. If the trustee claims both general administrative expenses²⁹ and section 506(c) expenses, may the trustee raid debtor equity for general purposes and later claim that her 506(c) expenses must now reduce the allowed secured claim? In the above hypothetical scenario, where the trustee owns debtor equity worth \$5, suppose the trustee has already spent this

26. See *Equitable Gas Co. v. Equibank, N.A. (In re McKeesport Steel Castings Co.)*, 799 F.2d 91, 94-95 (3d Cir. 1986); *In re Olympia Holding Corp.*, 127 B.R. 478, 480 (Bankr. M.D. Fla. 1991) (Proctor, J.); *In re MMS Builders, Inc.*, 101 B.R. 426, 429 (Bankr. D.N.J. 1989) (Fisher, J.); *In re Richards Pontiac, Inc.*, 24 B.R. 758, 760-61 (Bankr. E.D.N.Y. 1982) (Hall, J.). But see *John Deskins Pic Pac, Inc. v. Flat Top National Bank (In re John Deskins Pic Pac, Inc.)*, 59 B.R. 809 (Bankr. W.D. Va. 1986) (Pearson, J.), in which a Chapter 7 trustee had rent obligations on store space and successfully charged all of it to the secured creditor because collateral was stored there. *Id.* at 814. Yet the premises were used for other purposes as well. *Id.* This was a case in which proration would have been just.

An early pitch for general sharing of expenses between secured and unsecured creditors occurs in Seymour J. Rubin, *Allocation of Reorganization Expenses*, 51 YALE L.J. 418 (1942). In this article Rubin argues that reorganization is for the benefit of both secured and unsecured creditors. See *id.* at 427. Therefore, undersecured creditors should assume a share of the trustee's expenses according to a ratio of encumbered assets to total assets. *Id.* at 430. When the secured creditor is undersecured, such a proposal is consistent with what the text has just suggested. Since the trustee is a hypothetical lien creditor as to assets not encumbered by claims of the secured creditors, Rubin's ratio reflects the proposition that the trustee's actions simultaneously benefits different lien creditors claiming different collateral. Rubin does not offer advice about allocating expenses when the secured creditor is oversecured, but his principle—that reorganization is partly for the benefit of secured creditors—leads to the conclusion that pro rata sharing is appropriate nevertheless. Whether the bankrupt estate consists of debtor equity or separate assets should not affect his argument. In this sense, I take issue in this Article with Rubin, who would uphold the pro rata cases criticized in the text above.

27. See *Warren v. Palmer*, 310 U.S. 132, 136 (1940) (Reed, J.) (interpreting Bankruptcy Act § 77(c)(6)); *In re Trengre*, 127 B.R. 552, 555 n.3 (E.D. Pa. 1991) (Pollack, J.).

28. Cf. *Acceptance Assocs. of Am., Inc. v. Zimmerman (In re H.P. Tool Mfg. Corp.)*, 12 B.R. 600, 601 (Bankr. E.D. Pa. 1981). In *H.P. Tool*, Judge Goldhaber awarded first priority to the secured claim, second to postpetition interest under § 506(b), and then to 506(c) expenses. *Id.* at 601-02. But, as cash proceeds were sufficient to pay all these claims, this priority can conveniently be dismissed as dictum.

29. That is, expenses not properly chargeable to the secured creditor under § 506(c).

amount on her lawyers.³⁰ Only after the equity cushion is depleted does the trustee seek 506(c) expenses of \$4 from the secured creditor. If the trustee had charged the 506(c) amount first, the secured claim would not have been reduced. But since the trustee dissipated the debtor equity first, a reduction of the secured claim becomes possible.

If the trustee can pull off this stunt, then criticism of the setoff cases or the pro rata rule is useless. The trustee can always invade the secured claim so long as the trustee is careful to dissipate debtor equity before the section 506(c) charge. Indeed, the failure of a trustee to accomplish a raid on debtor equity might well constitute a breach of fiduciary duty to the general creditors.

A marshalling rule might be developed to require the trustee to charge the 506(c) expenses first and any other expenses second. This kind of rule would protect the secured claim against trustee predation, but it is tantamount to reserving part of the surplus for the secured creditor. To put it another way, whenever debtor equity exists, a marshalling rule implies that the secured creditor has the right to insist that the equity be adequately protected against depreciation, so that equity will exist to soak up expected 506(c) expenses of the trustee.³¹

There is at least one objection to preserving debtor equity for the trustee's unaccrued collection expenses. If equity must be preserved for this purpose, then secured parties will be able to expropriate the equity as the secured creditor's postpetition interest and collection expenses accrue under section 506(b).³² Although some courts do hold that debtor equity must be reserved in case 506(b) entitlements accrue,³³ the better view is that the secured creditor cannot, for this reason, prevent a trustee from

30. See 11 U.S.C. § 331 (1988) (permitting interim compensation to lawyers).

31. For cases arguably following such a rule, see *General Elec. Credit Corp. v. Peltz* (*In re Flagstaff Foodservice Corp.*), 762 F.2d 10, 11 (2d Cir. 1985) (Van Graafeiland, J.) (refusing a 506(c) award where debtor equity was dissipated); *In re Dixie-Shamrock Oil & Gas, Inc.*, 39 B.R. 115, 118 (Bankr. M.D. Tenn. 1984) (Paine, J.) (requiring that surplus cash collateral be spent only on maintaining the collateral).

32. But in a case where § 506(c) expenses are incurred, the two equity preservation rules might cancel each other out. Suppose that the collateral is worth \$100, and the secured creditor claims \$90 at the time of the petition. The secured creditor is entitled to 10% interest under § 506(b). The bankruptcy proceeding is expected to last a year. Therefore, the entire equity cushion of \$10 must be preserved so that one year's interest can accrue against it. But now suppose that the trustee has \$5 in 506(c) expense. The trustee may now invade the secured claim because there is effectively no debtor equity left in the collateral.

33. See *Hamilton Bank v. Diaconx Corp.* (*In re Diaconx Corp.*), 69 B.R. 333, 341-43 (Bankr. E.D. Pa. 1987) (Fox, J.) (holding that undersecured creditor could have postpetition interest and collection costs because equity cushion existed at the start of bankruptcy); see also *In re D.W.G.K. Restaurants, Inc.*, 84 B.R. 684, 686 (Bankr. S.D. Cal. 1988) (Hargrove, J.) (arguing in dictum that secured creditor has a contractual right to see debtor equity preserved).

using property of the estate such as debtor equity.³⁴

Therefore, if a marshalling rule is instituted, it should be severely limited to the following principle: If debtor equity still exists at the time a trustee wishes to recover an expense within the scope of section 506(c), the trustee must first use this equity to pay 506(c) expenses. If no equity exists at that time, then the secured claim may be invaded under the auspices of section 506(c). Obviously, this rule sends less than satisfactory signals to a bankruptcy trustee, but it is the best rule logic and consistency can offer at present.

At a higher level of generality, it might be asked whether the priority implied by section 506(c) is advisable, or whether it would be better if the trustee were prohibited from invading the secured claim to recover expenses. It may be universally true, as was said earlier, that enforcing officers have the top priority for their expenses.³⁵ But it must also be admitted that the predominant pattern is for the *enforcing* lien creditor to invoke the services of the enforcing officer. In bankruptcy, the enforcing lien creditor is the junior lienor—the bankruptcy trustee³⁶—not the senior secured creditor. Whereas under state law the senior liens are typically not foreclosable for the benefit of junior lien creditors,³⁷ in bankruptcy the junior trustee can foreclose senior secured creditors.³⁸ For example, assume that three lien creditors, *A*, *B*, and *C*, are first, second, and third in line for a given piece of collateral. Under state law, if *B* wishes to foreclose, *B* can generally foreclose *C*, but not *A*. That is, any buyer of the collateral takes subject to *A*'s lien, but takes free of *C*'s lien. In other words, the foreclosure sale has no legal effect on *A* whatsoever. Therefore, if the enforcing officer overspends, it harms *B* or *C*. Overspending cannot adversely affect *A*.

Bankruptcy is different. The trustee is a junior lien creditor who can cause a senior lien creditor to be foreclosed.³⁹ As such, the trustee can make the senior lien creditors pay the enforcement bill. This exportation of costs from the junior to the senior lien creditor in bankruptcy is seldom allowed under state law.

34. See *In re Triplett*, 87 B.R. 25, 27 (Bankr. W.D. Texas 1988) (secured creditor had no right to complain that the debtor-in-possession was using the equity cushion); Carlson, *supra* note 21, at 389-91.

35. See *supra* text accompanying note 12.

36. See 11 U.S.C. § 544(a)(1) (1988) (trustee has the rights of a judicial lien creditor).

37. See U.C.C. § 9-504(4) (1972). But see David Gray Carlson, *Death and Subordination Under Article 9 of the Uniform Commercial Code: Senior Buyers and Senior Lien Creditors*, 5 CARDOZO L. REV. 547, 565-71 (1984) (describing exceptions).

38. 11 U.S.C. § 363(f)(3) (1988).

39. *Id.*

The argument against this state of affairs would emphasize the fact that the trustee ought to have the incentive to deal with the collateral only when the general creditors would benefit. That is, only when the bankrupt estate increases by more than the administrative expenses of dealing with the collateral should the trustee be dealing with the collateral at all. If this principle were followed, then the value added by the trustee should always be sufficient to cover these administrative expenses. It should never be necessary to reimburse the trustee out of the allowed secured claim. A repeal of section 506(c) would therefore encourage the trustee to spend only when the general creditors would benefit.

Still, such a rule would leave the trustee exposed in the case of good faith enterprises gone awry. Protection of the trustee's business judgment comprises a powerful argument in favor of section 506(c). Whether this argument prevails depends upon the degree of confidence held in bankruptcy trustees—whether they adhere to their fiduciary duties (in which case section 506(c) is advisable) or whether they generally do not (so that economic incentives are needed to insure proper behavior). This latter pessimistic view supports the repeal of section 506(c).

Even if section 506(c) has no right to exist, it nevertheless does so, for the time being. Accordingly, 506(c) expenses must be accorded a priority above any claim by a secured creditor. But if a positive debtor equity exists, then this equity must absorb 506(c) expenses before the secured claim may be reduced in size.

B. Standing

The foregoing discussion establishes the trustee's priority for 506(c) expenses. Can a claimant other than the trustee who has benefitted the secured creditor take over this priority and bring suit directly against the secured creditor? Or must the trustee be the person seeking compensation under section 506(c)? Section 506(c) mentions only recoveries by the trustee herself, not recoveries by others acting for the trustee.

Courts are split on this question.⁴⁰ The cases that permit only the

40. See generally *Savage*, *supra* note 13, at 435-36 ("The courts are still applying the pre-Code theories on a case by case basis, using individual passages of the 506(c) language to justify whatever conclusion they reach."). For a liberal standing rule, see *New Orleans Pub. Serv., Inc. v. First Fed. Sav. & Loan Ass'n (In re Delta Towers, Ltd.)*, 924 F.2d 74, 76-77 (11th Cir. 1991) (Johnson, J.); *Equitable Gas Co. v. Equibank, N.A. (In re McKeesport Steel Castings Co.)*, 799 F.2d 91, 93-94 (3d Cir. 1986) (Higginbotham, J.). For the rule that only the trustee has standing, see *In re Scopetta-Senra Partnership III*, 127 B.R. 282, 283-84 (Bankr. S.D. Fla. 1991) (Cristol, J.); *In re Proto-Specialties, Inc.*, 43 B.R. 81, 83 (Bankr. D. Ariz. 1984) (Nielsen, J.). Some courts have specifically stated that attorneys lack standing to recover fees under § 506. See *In re Manchester Hides, Inc.*, 32 B.R. 629, 632-33 (Bankr. N.D. Iowa 1983) (Thinnes, J.); *In re Codesco*, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) (Schwartzberg, J.). One

trustee to seek 506(c) expenses from secured creditors, however, seem ill-advised. Suppliers can easily arrange for the trustee to make the motion for them. Such a rule only forces suppliers into useless procedural maneuvers.

The liberal view of standing—that claimants other than the trustee can collect 506(c) expenses directly from the secured creditor—is reflected in a case some authorities have identified as the origin of section 506(c). In *New York Dock Co. v. The Steamship Poznan*,⁴¹ Justice Stone wrote,

The most elementary notion of justice would seem to require that services or property furnished upon the authority of the court or its officer, acting within his authority, for the common benefit of those interested in a fund administered by the court, should be paid from the fund as an "expense of justice."⁴²

This sentiment certainly implies that the name of the movant is irrelevant, so long as the service to the "common fund" was necessary and proper.

Of course, suppliers ought to have standing under section 506(c) only when the trustee owes the expense to the suppliers. For example, in *In re Proto-Specialties, Inc.*,⁴³ the debtor's landlord was not permitted to share in the recovery of storage expenses incurred after the landlord successfully evicted the bankrupt estate from his premises.⁴⁴ Once evicted, the trustee owed no rent to the landlord. Hence, the landlord properly was excluded from section 506(c) recovery because post-eviction rent was not an expense the trustee owed the landlord.

In contrast, a junior secured creditor in *In re Landing Associates*⁴⁵ paid off a senior lien creditor and then sought reimbursement out of the proceeds of the secured creditor's own collateral.⁴⁶ The senior lien creditor was a nonrecourse tax creditor,⁴⁷ so that the trustee did not, properly speaking, owe the senior lien creditor anything, in the in personam sense. Nevertheless, the junior secured creditor should have had standing to recover from its own collateral under section 506(c), even though the

court has held that another secured creditor has standing to impose § 506(c) expenses on other secured parties. *In re Stable Mews Assocs.*, 49 B.R. 395, 398 (Bankr. S.D.N.Y. 1985) (Buschman, J.), *appeal dismissed*, 778 F.2d 121 (2d Cir. 1985).

41. 274 U.S. 117 (1927). On these claims of origin, see *supra* note 13.

42. *New York Dock*, 274 U.S. at 121.

43. 43 B.R. 81 (Bankr. D. Ariz. 1984) (Nielsen, J.).

44. *Id.* at 83.

45. 122 B.R. 288 (Bankr. W.D. Tex. 1990) (Clark, J.).

46. *Id.* at 298.

47. *See id.*

trustee had no liability for the senior tax claim. To see why this is so, some background assumptions should be set forth.

First, since the junior secured creditor was undersecured, its claim was subject to subdivision under section 506(a) into its secured and unsecured parts. The security interest for the unsecured deficit would be void under section 506(d). For example, suppose the senior tax lien was for \$15, the total claim by the junior secured creditor was \$100, and the collateral was worth \$90 if unencumbered. On these numbers, the junior secured creditor would have a secured claim of \$75 and an unsecured claim of \$25. The security interest for the \$25 unsecured deficit is deemed void under section 506(d),⁴⁸ but is preserved for the benefit of the estate under Bankruptcy Code section 551.⁴⁹ When the junior secured creditor pays the tax lien, the junior secured creditor continues to have an \$75 secured claim, but now there is \$15 in new debtor equity that is encumbered by the trustee's avoided-but-preserved lien for \$25. So far, the junior secured creditor has obtained no direct benefit from paying the senior tax lien, but the trustee's lien is benefited by \$15. The junior secured creditor therefore should have a valid 506(c) claim against the trustee, who is a secured creditor benefited by payment of the tax.⁵⁰

In fact, the identical result should be reached even without the aid of section 506(c). It is possible to view the junior secured creditor as having taken an assignment of the senior lien, which could then be asserted against the collateral, regardless of section 506(c). Nothing in the Bankruptcy Code requires that the bankruptcy court approve assignments of secured claims in advance.⁵¹

In *Landing Associates*, however, Judge Leif Clark erroneously disallowed reimbursement to the junior secured creditor (now senior), because the buyout constituted postpetition credit without the court's consent.⁵² There was no reason for Judge Clark to view this as a case of illegally tendered postpetition credit, because the junior secured creditor's claim did not burden the bankrupt estate one iota. Rather, the facts in *Landing Associates* illustrate how the "standing" controversy under

48. 11 U.S.C. § 506(d) (1988).

49. *Id.* § 551.

50. *Cf.* Tycon I Bldg. Ltd. Partnership v. County of Fairfax (*In re* Tycon I Bldg. Ltd. Partnership), 129 B.R. 78, 80-81 (Bankr. E.D. Va. 1991) (Tice, J.) (allowing a debtor-in-possession 506(c) compensation for expense in reducing size of tax lien in a way that benefited junior secured creditor).

51. *Landing Assocs.*, 122 B.R. at 298. Bankruptcy Rule 3001(e) only requires that notice of an assignment of a claim be filed, and even then only if the proof of claim had already been filed by the assignor. See Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 21-22 (1990).

52. See 11 U.S.C. § 364(c) (1988) (requiring court approval for postpetition credit).

section 506(c) resembles assignments of secured claims. If a trustee has a right to charge the collateral, and if a third creditor "buys" this claim, the third creditor should be allowed to enforce what amounts to a senior lien on the collateral.

C. "From Property"

Whereas the previous section discusses who may be a plaintiff under section 506(c), there is also an issue as to who may be a defendant. Section 506(c) provides that the trustee may recover certain expenses "from property."⁵³ Typically this is precisely what happens: the trustee sells the property⁵⁴ or collects an account receivable⁵⁵ and then seeks permission to take a cash amount equal to the trustee's expense. But what happens if the property has already been abandoned? Or what if the property is to be used in a reorganization? In these circumstances, the trustee has not reduced the property into cash. Does the requirement that the trustee recover "from property" bar in personam suits against the secured creditor?

Apparently not. Courts have not hesitated to impose in personam liability on secured creditors to whom property has been abandoned,⁵⁶ even when the secured creditor was not required to sell and foreclose the collateral.⁵⁷ This seems entirely appropriate. Whether the trustee's right to section 506(c) expenses is characterized as a lien or—as 506(c)'s admiralty ancestor was characterized—an equitable charge on property,⁵⁸ secured creditors who take abandoned property convert the trustee's

53. *Id.* § 506(c).

54. *See, e.g.,* Equitable Gas Co. v. Equibank, N.A. (*In re McKeesport Steel Castings Co.*), 799 F.2d 91, 92-93 (3d Cir. 1986) (Higginbotham, J.); *Schindler v. Sharak* (*In re Salzman*), 83 B.R. 233, 240-41 (Bankr. S.D.N.Y. 1988) (Schwartzberg, J.).

55. *See, e.g., In re Johnson*, 47 B.R. 204, 205 (Bankr. W.D. Wis. 1985) (Martin, J.); *Communication & Studies Int'l, Ltd. v. Bank of Am., N.T. & S.A.* (*In re World of English, N.V.*), 21 B.R. 524, 527 (Bankr. N.D. Ga. 1982) (Drake, J.).

56. *In re Trim-X, Inc.*, 695 F.2d 296, 298-99 (7th Cir. 1982) (Swygert, J.); *In re AFCO Enters., Inc.*, 35 B.R. 512, 517-18 (Bankr. D. Utah 1983) (Clark, J.).

57. *In re P.C., Ltd.*, 110 B.R. 232, 235 (E.D. La. 1990) (Arceneaux, J.) (because collateral was transferred to the secured creditor as an "asset payment," creditor had no obligation under state law to sell the property, yet trustee could still recover personally from the creditor under § 506(c)).

58. In developing a rule like § 506(c) for admiralty, Justice Stone thought charges of this sort should not be called liens. *See New York Dock Co. v. The S.S. Poznan*, 274 U.S. 117, 121 (1927). "Such preferential payments are mere incidents to the judicial administration of a fund," he wrote. "They are not to be explained in terms of equitable liens in the technical sense . . ." *Id.*

The implications of this venerable dictum are far from clear. *See* GRANT GILMORE & CHARLES L. BLACK, JR., *THE LAW OF ADMIRALTY* 603-05 (2d ed. 1975) (speculating on what this dictum might mean for admiralty lien foreclosures).

property to their own use, in the tortious sense. Under a theory of conversion, secured creditors have an in personam liability to a bankruptcy trustee.

Nevertheless, several points can be derived from section 506(c)'s reference to a trustee's recovery "from property." First, the limitation of recovery "from property" ought to mean that the maximum exposure of a secured creditor is the value of the property. That is, section 506(c) might justify the complete loss of all value from the collateral, but it cannot justify surcharging the secured creditor for amounts above and beyond its value. Otherwise, the trustee is not only recovering "from property," but "from property" and from the secured creditor's own pockets as well.

This principle may come in handy with regard to environmental claims which, these days, can far exceed the value of the collateral itself. Secured creditors are supposed to be immune from the liability imposed by the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) on "owners" of toxic waste facilities.⁵⁹ The interpretation given to the words "from property" serves to make clear that the maximum liability of a secured creditor for toxic waste liability is the value of the property. In other words, section 506(c) might include toxic waste cleanup expenses, but the secured creditor is, in essence, a nonrecourse creditor vis-à-vis CERCLA plaintiffs.⁶⁰

59. See 42 U.S.C. § 9601(20)(A) (1988) (generally excluding secured creditors from definition of "owner" of a "facility"); *id.* § 9607(a)(1) (rendering an "owner of a facility" liable for toxic waste cleanup).

60. It is possible, however, that § 506(c) applies to secured creditors, if the secured creditor is "benefited" by toxic waste cleanup. Anyone who buys a "facility" becomes liable for cleanup. *Id.* § 9607(a)(1). Therefore, a buyer will discount her bid for collateral by the expected amount of cleanup. See David Gray Carlson, *Successor Liability in Bankruptcy: Some Unifying Themes of Intertemporal Creditor Priorities Created by Running Covenants, Products Liability and Toxic Waste Cleanup*, 50 LAW & CONTEMP. PROBS. 119, 151-56 (1987). When the property has been decontaminated, the collateral buyers will bid more for the property. This extra value is "benefit" within the meaning of § 506(c).—*In re Better-Brite Plating, Inc.*, 105 B.R. 912, 918 (Bankr. E.D. Wis. 1989) (Ihlenfeldt, J.) (granting EPA "administrative expense liens with priority over secured creditors to the proceeds of any sale of the property subsequent to decontamination").

In re T.P. Long Chemical, Inc., 45 B.R. 278 (Bankr. N.D. Ohio 1985), is an example of no benefit to the secured creditor, who claimed a security interest in all personal property, including barrels of sodium monochloride—property that had no value, because disposal costs outweighed its worth. *Id.* at 288. The secured creditor had auctioned off other, valuable personal property. *Id.* Thereafter, the EPA removed the toxic barrels and sought to recover from the secured creditor under § 506(c). *Id.* Judge White properly ruled that the charge did not "benefit" the secured creditor. *Id.* at 287-88. If the EPA cleanup had made the barrels valuable—for instance, if a buyer would now pay \$100 for well-scrubbed barrels—the EPA would be able to recover its prodigious cleanup costs "from property"—that is, from the \$100. But the secured creditor would have no personal liability beyond that amount.

Second, if section 506(c) authorizes in personam liability for secured creditors, only secured parties *of the debtor* should be charged. This requirement seems obvious, but it can become confusing in cases involving security interests on leased property. For example, when a secured creditor claims a security interest in the reversionary interest of property, but not in the leasehold, and when the lessee is bankrupt, the trustee should not be able to reach the secured creditor, because the secured creditor's security interest does not encumber property of the bankrupt estate. But when the security interest encumbers the leasehold only, or both the leasehold and the reversionary interest, then a charge is appropriate, because the leasehold in the bankrupt estate is encumbered by the secured creditor's interest.⁶¹ In this latter case, actions to preserve the property are for the joint benefit of the lessor and the secured creditor. This joint benefit suggests that some sort of apportionment of the expense is appropriate, so that the secured creditor does not have to bear the entire expense.⁶²

Third, "from property" ought to mean that the trustee cannot collect from the secured creditor until the collateral is liquidated or abandoned. Until the collateral is liquidated (or converted to the secured creditor's own use), the trustee's charge on the collateral is still inchoate—not yet mature. Thus, in *In re Beker Industries Corp.*,⁶³ Judge Buschman prohibited abandonment of the collateral, but indicated that section 506(c) expenses could be collected only if and when the collateral was finally abandoned.⁶⁴ This principle, if applied in Chapter 11, suggests that the debtor-in-possession cannot collect until the plan is confirmed. At that time, if the secured creditor is to be crammed down, compensation to the debtor-in-possession could come in the form of lowering the valuation of the secured claim and raising the amount of the unsecured deficit.

Hence, even though the words "from property" have not altogether barred in personam suits against secured creditors, they do indicate whether specific secured creditors are liable, the limit of a secured creditor's liability, and when this liability becomes mature and presently owing.

61. *In re Olympia Holding Corp.*, 127 B.R. 478, 480-81 (Bankr. M.D. Fla. 1991) (Proctor, J.) (encumbered truck leased to corporate subsidiary).

62. *But see id.* at 482 ("The Trustee is not required to show that the marshalling was for the sole and exclusive benefit of [the secured creditor] in order to be entitled to a surcharge under section 506(c).").

63. 64 B.R. 900 (Bankr. S.D.N.Y. 1986).

64. *Id.* at 908-10.

D. The Effect of a 506(c) Charge on the Secured Creditor's Unsecured Deficit Claim

Suppose a court awards 506(c) expenses to the trustee or her subrogee. What is the effect of this award on the secured creditor's total claim in bankruptcy? Section 506(c), of course, implies that a creditor is undersecured. As was stated earlier, section 506(c) exists solely to invade the secured claim,⁶⁵ and this can occur only when there is no equity cushion in the collateral. Hence, section 506(c) makes itself relevant only when the total claim of the secured creditor exceeds the value of the collateral.

According to section 506(a), the claim of an undersecured creditor must be divided into two separate claims—a wholly secured claim and a wholly unsecured claim.⁶⁶ Expenses awarded under section 506(c) are awarded "from the property." Does this award reduce the secured claim *and* raise the unsecured claim simultaneously? Or does the award simply reduce the secured claim and leave the unsecured deficit intact? No judicial or academic opinion has been hazarded on this question. The answer depends on precisely how one characterizes a 506(c) charge—a characterization likely to be controversial.

Under Article 9 of the Uniform Commercial Code, it is clear that an analogous charge increases the deficit claim the secured creditor is entitled to recover from the debtor. According to section 9-504(1):

A secured party after default may sell, lease or otherwise dispose of any or all of the collateral in its then condition or following any commercially reasonable preparation or processing. . . . The proceeds of disposition shall be applied in the order following to

(a) the reasonable expenses of retaking, holding, preparing for sale or lease, selling, leasing and the like and, to the extent provided for in the agreement and not prohibited by law, the reasonable attorneys' fees and legal expenses incurred by the secured party;

(b) the satisfaction of indebtedness secured by the security interest under which the disposition is made;

(c) [to junior secured parties and finally to the debtor].⁶⁷

Under this provision, expenses analogous to 506(c) charges would decrease the recovery from the collateral and would increase the unsecured deficit. For example, suppose collateral is sold for \$80, and the secured

65. See *supra* text accompanying notes 12-39.

66. 11 U.S.C. § 506(a) (1988).

67. U.C.C. § 9-504(1) (1972).

creditor claims \$100. The expenses of sale are \$5. Section 9-504(1)(a) authorizes the secured creditor to take out \$5 before any of its claim is extinguished by payment. Thus, from the collateral, \$75 is available to pay the secured creditor's claim. The deficit is \$25.

Transposed to the bankruptcy courts, this principle allows the secured creditor to claim a larger deficit if the collateral is invaded to cover the trustee's 506(c) expenses. The payment of these expenses is not the payment of the secured creditor's claim. To the extent the collateral does not pay this claim, the secured creditor should have a deficit unsecured claim.

A passage from *United Savings Ass'n v. Timbers of Inwood Forest Associates*⁶⁸ arguably requires that the unsecured portion of the claim be left intact, even while the secured claim is reduced.⁶⁹ *Timbers* dealt with a much different issue—whether the right of adequate protection includes the right of undersecured creditors to receive postpetition interest.⁷⁰ Writing about the meaning of section 506(a), Justice Scalia contended that undersecured creditors must *not* have the right to interest.⁷¹ Otherwise,

the "value of such creditor's interest" would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues—since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time. No one suggests this was intended.⁷²

This formulation can be criticized for a certain lack of intelligibility.⁷³ Nevertheless, the words of U.S. Supreme Court justices are often taken very seriously, for better or worse, even when they are dictum. The

68. 484 U.S. 365 (1988).

69. *See id.* at 373-74.

70. *Id.* at 369.

71. *Id.* at 371.

72. *Id.* at 372.

73. To quote my own critique of this interpretation of § 506(c):

It may be observed that, over time, the face amount of the secured claim will increase if interest is allowed to accrue, but face amount is economically meaningless. *Value* is what counts in financial markets, and Section 361 calls for protection of *value*. If face amount is allowed to increase by the accrual of postpetition interest, the *value* of the secured claim (as of today) may stay the same, if the right interest rate is chosen. It will *not* necessarily increase, as Scalia suggests. The change in the *face* amount of a claim is inevitable if the *value* of the claim is to be protected. In arguing that postpetition interest entitlements change the value of an undersecured creditor's claim, Scalia confounds the concept of value and face amount and therefore has not developed a strong argument for his view that undersecured creditors have no postpetition interest entitlement to interest.

Carlson, *supra* note 1, at 603.

words just quoted, for example, have already been taken to mean that collateral must be valued at the time a bankruptcy petition is filed⁷⁴—a very controversial proposition.⁷⁵ The theory of this holding appears to be that if another time for valuation is chosen, the stated ratio changes over time, in violation of Scalia's theorem.

If we stipulate the importance of a fixed ratio between the secured and unsecured claims of an undersecured creditor, then section 506(c) should have no effect on the unsecured claim. Rather, the expenses come out of the fund reserved for the secured claim without any readjustment of the ratio between the secured and unsecured claim. For example, suppose the secured creditor claims \$100, but the collateral is valued at \$80. The ratio of secured to unsecured claims is four to one. Now suppose that the court awards the trustee \$5 in 506(c) expenses. The award affects neither the unsecured claim nor the secured claim, except that the secured creditor does not get the full claim. Instead the secured claim remains at \$80, but with \$5 going to the trustee. The secured creditor receives \$75 from the collateral and the usual dividend on the \$20 unsecured claim. Meanwhile, the ratio of four to one is maintained.

A final doubt must be expressed regarding this fixed ratio of secured to unsecured claims. If cash proceeds come into the estate, a secured creditor's lien attaches to them, if the prepetition security agreement so provides.⁷⁶ The continued ownership of proceeds guarantees that the ratio of secured to unsecured debt cannot be maintained in any case involving overencumbered income-producing collateral.⁷⁷ Similarly, if the secured debt is paid down over time, which section 361(1) clearly permits by way of adequate protection,⁷⁸ the ratio is destroyed. Thus, the Scalian ratio violates the clear meaning of the Bankruptcy Code and, on this

74. *In re Flagler-at-First Assocs.*, 101 B.R. 372, 377 (Bankr. S.D. Fla. 1989) (Cristol, J.).

75. See David Gray Carlson, *Time, Value, and the Rights of Secured Creditors in Bankruptcy, or, When Does Adequate Protection Begin?*, 1 J. BANKR. L. & PRAC. 113, 127-28 (1991); Patrick Fitzgerald, Comment, *Bankruptcy Code Section 506(a) and Undersecured Creditors: What Date for Valuation?*, 34 UCLA L. REV. 1953, 1958 (1987).

76. 11 U.S.C. § 552(b) (1988).

77. Although this theory has been overlooked, it ought to be that an undersecured creditor has only very limited rights to cash proceeds under § 552(b). First, the legislative history to § 552 indicates that proceeds should not have the effect of improving an undersecured creditor's position. See *infra* text accompanying notes 82-85. Second, the undersecured creditor's deficit claim is no longer secured at all, by virtue of § 506(d) avoidance.

Nevertheless, it is still true that the proceeds, as they come in, are cash collateral within the meaning of § 552(b). If the cash can no longer go to secure the heretofore unsecured deficit, at least the proceeds constitute an equity cushion for the secured claim the undersecured creditor continues to have under § 506(a). Against this equity cushion postpetition interest and collection expenses might accrue. This theory is explored in greater detail in Carlson, *supra* note 75, at 128-31.

78. 11 U.S.C. § 361(1) (1988).

basis, might be disregarded. If so, a bankruptcy court might still increase the unsecured claim for every dollar of 506(c) compensation to a trustee.⁷⁹ In a case involving dividends to unsecured creditors (which do occur from time to time), such a right to an increased unsecured deficit is important.

E. Charging Secured Creditors Without the Aid of Section 506(c)

As the previous discussion has shown, section 506(c) exists to justify the invasion of the secured claim by the trustee.⁸⁰ But section 506(c) expressly requires a demonstration that the expenses being reimbursed actually benefited the secured creditor whose claim is being invaded. Some courts are hostile to the idea that *any* reorganization proceeding benefits a secured creditor.⁸¹ Given such an attitude, it will be very difficult indeed to bring the general expenses of bankruptcy administration within the scope of section 506(c). It becomes relevant, then, to look at other ways that a trustee might invade a secured claim *without* the aid of section 506(c).

1. Disencumbering Cash Proceeds Under Section 552(b)

Section 552(b) provides that a secured creditor with the prepetition right to cash proceeds continues to have the right to postpetition proceeds, "except to any extent that the court . . . orders otherwise."⁸² According to the legislative history, "[t]he provision allows the court to consider the equities in each case. In the course of such consideration, the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party."⁸³

In *In re Cerrico Realty Corp.*,⁸⁴ Judge Duberstein expressed the view that section 552(b) authorizes the use of cash collateral without the consent of the secured creditor although, on the facts before him, he was unwilling to authorize use without better evidence on the nature of the

79. Ironically, Justice Scalia used the integrity of § 552 to bolster his position that undersecured creditors should not get postpetition interest. In his view, postpetition interest was like rent on collateral. See *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 374 (1988). This is a dubious assertion. Section 552 requires an *agreement* to reserve a lien on rents. 11 U.S.C. § 552(b) (1988). Scalia thought that an automatic right to postpetition interest would produce "rent" even when an agreement did not provide for it. *Timbers*, 484 U.S. at 374.

80. See *supra* text accompanying notes 12-39.

81. These cases are discussed *infra* in the text accompanying notes 256-72.

82. 11 U.S.C. § 552(b).

83. 124 CONG. REC. 32,400 (1978) (statement of Rep. Edwards).

84. 127 B.R. 319 (Bankr. E.D.N.Y. 1991).

expenditures.⁸⁵ Yet it is hard to believe that the standards for expenditures under section 552(b) are different from the standards under section 506(c). The thrust of the legislative history is that the right to postpetition cash proceeds should not become a vehicle whereby a secured creditor improves her position. This strongly suggests that the trustee expenditures referred to are nothing else but the expenditures properly chargeable to the secured creditors under section 506(c). Such expenditures, if not charged to the secured creditor, would tend to improve the secured creditor's position. In addition, the trustee's expenditures to be examined must relate to the cash proceeds generated by those expenditures. Hence, it is far from clear that section 552(b)'s legislative history adds anything not already implicit in section 506(c).

2. The Effect of Interim Compensation to Lawyers and Accountants on Secured Creditors

Another theory by which secured creditors can be made to bear the ordinary expenses of bankruptcy administration—without reference to section 506(c)—states that administrative expenses might outrank a secured claim whenever they are awarded as interim compensation to lawyers and accountants under Bankruptcy Code sections 330 and 331.⁸⁶ This suggestion has some support in the case law,⁸⁷ but the weight of authority is heavily against it.⁸⁸

Of course, postpetition creditors who aid in the administration of the estate⁸⁹ are entitled to a very high priority vis-à-vis other general creditors.⁹⁰ But secured creditors are supposed to outrank these administrative claims.⁹¹ Unless the trustee's expense can be brought under sec-

85. *Id.* at 323-24.

86. 11 U.S.C. §§ 330, 331 (1988).

87. See *In re Callister*, 15 B.R. 521 (Bankr. D. Utah 1981), *appeal dismissed*, 673 F.2d 305 (10th Cir. 1982), *aff'd sub nom. Ingersoll-Rand Fin. Corp. v. Callister*, 13 Bankr. Ct. Dec. (CRR) 21 (10th Cir. 1984). For a full discussion of *Callister*, see *infra* notes 104-09 and accompanying text.

88. See *infra* notes 109-14 and accompanying text.

89. See 11 U.S.C. § 503 (1988) (describing the rules for qualifying for this high priority).

90. *Id.* § 507(a)(1).

91. In Chapter 7 cases, the superpriority of secured creditors to administrative creditors follows from the fact that secured creditors are entitled to distributions under Bankruptcy Code § 725; administrative creditors obtain distributions under § 726(a), which, by the terms of § 725, takes effect only after the § 725 distributions have already occurred. *Id.* § 725. In Chapter 11, dissenting secured creditors must always be given the value of their collateral. *Id.* § 1129(b)(2)(A). Administrative creditors have the right to be paid in cash and in full. *Id.* § 1129(a)(9)(A). Hence, a plan that cannot cover both the secured claims and the administrative claims cannot be confirmed and must convert to Chapter 7, where secured creditors come first.

tion 506(c), secured creditors should be held harmless from expenses of the bankrupt estate.⁹² This much is obvious—when collateral is adequate to satisfy the secured claim. If the collateral has disappeared, the secured creditors are given a superpriority even higher than the priority of administrative claimants.⁹³ This superpriority is useless if the estate has no assets left; when unencumbered assets do exist, however, secured creditors deprived of their collateral outrank any administrative creditor.

Most administrative creditors are not paid until the estate is liquidated or a reorganization plan is confirmed.⁹⁴ There are, however, at least two very important exceptions to this principle. First, the trustee may expend unencumbered funds in the ordinary course of business.⁹⁵ Second, trustees, their lawyers, and their "professional person[s]" are entitled to interim compensation during the pendency of the proceeding.⁹⁶

This interim compensation ought not to be a threat to secured creditors.⁹⁷ Interim compensation may only be awarded out of property of

92. *In re Energy Coop., Inc.*, 55 B.R. 957, 964 (Bankr. N.D. Ill. 1985) (Hertz, J.) ("If at the end of the case, there are no assets from which to pay administrative expenses beyond those subject to a valid secured claim, the professional is forced to forego compensation unless he can demonstrate that he has met the standards of section 506(c).").

93. 11 U.S.C. § 507(b) (1988). According to this provision:

If the trustee . . . provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(1) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.

Id.

94. *In re Callister*, 15 B.R. 521, 534 (Bankr. D. Utah 1981) (Mabey, J.), *appeal dismissed*, 673 F.2d 305 (10th Cir. 1982), *aff'd sub nom. Ingersall-Rand Fin. Corp. v. Callister*, 13 Bankr. Ct. Dec. (CRR) 21 (10th Cir. 1984).

95. 11 U.S.C. § 363(c)(1) (1988). The trustee's power to expend funds in the ordinary course of business is assumed in any Chapter 11 case, unless the court orders otherwise. *Id.* § 1108.

96. *Id.* §§ 330, 331. According to § 331,

[a] trustee, an examiner, a debtor's attorney, or any professional person employed under section 327 or 1103 of this title may apply to the court not more than once every 120 days after an order for relief in a case under this title, or more often if the court permits, for such compensation for services rendered before the date of such an application or reimbursement for expenses incurred before such date as is provided under section 330 of this title. After notice and a hearing, the court may allow and disburse to such applicant such compensation or reimbursement.

Id. § 331.

97. Nor is the payment of interim compensation a threat to other administrative claimants. In *In re IML Freight, Inc.*, 52 B.R. 124 (Bankr. D. Utah 1985), Judge Glen Clark ruled that the right to interim compensation does not mean that professional persons had a higher priority than the standard administrative claimant. *Id.* at 140. Hence, Judge Clark denied

the estate. Or, to be more precise, a secured creditor's collateral may be used to pay the trustee's lawyers only if the secured creditor consents⁹⁸ or the security interest receives adequate protection.⁹⁹ For example, the cash collateral might be replaced with equivalent illiquid collateral.¹⁰⁰ The point is that, ultimately, the bankrupt estate should bear the cost of professional services, unless those services directly benefit the secured creditor and hence qualify as 506(c) expenses.

If interim compensation has been awarded, and if collateral later dissipates to such a degree that secured creditors have been denied adequate protection for their security interests, any administrative claimant who received interim compensation should give it back, to the extent necessary to make the secured creditors whole. This follows from the secured creditors' remedy for failed adequate protection—a superpriority that outranks even the trustee's priority.¹⁰¹ It is a prime feature of junior priority that any payment received before the seniors are paid is only provisional.¹⁰² Many courts have held that interim compensation is subject to return if some senior creditor appears on the scene later.¹⁰³

Nevertheless, one case seems to say (and has been read to say) that if the lawyers have been paid on an interim basis under section 331, and if secured creditors later lose their collateral, these attorneys do not have to give back their ill-gotten fees to make the secured creditors whole. In *In re Callister*¹⁰⁴ a secured creditor with a superpriority claim under section 507(b) asked for a declaration that this claim outranked any interim compensation awarded under section 331. Judge Mabey refused to give any such assurance, stating that when security interests encumber all assets of a bankrupt debtor, the attorneys could not otherwise be paid:

Section 331 encourages . . . volunteerism and, as an inducement to work for the estate, is a vital provision of the [Bankruptcy Code]. Requests for adequate protection in Chapter 11 are ubiquitous; each raises the spectre of a superpriority. If the

interim compensation until the trustee could show that it would not lead to a preference of the professional persons over the other administrative claimants. *Id.* at 139.

98. See 11 U.S.C. § 363(c)(2)(A) (1988) (governing cash collateral). In noncash cases, secured creditor consent is always grounds to invade collateral to cover ordinary administrative expenses. See *infra* text accompanying notes 163-73.

99. 11 U.S.C. § 363(e).

100. *Id.* § 361(2).

101. *Id.* § 507(b).

102. David Gray Carlson, *A Theory of Contractual Debt Subordination and Lien Priority*, 38 VAND. L. REV. 975, 993-96 (1985).

103. See *infra* notes 110-11 and accompanying text.

104. 15 B.R. 521 (Bankr. D. Utah), *appeal dismissed*, 673 F.2d 305 (10th Cir. 1982), *aff'd sub nom.* Ingersoll-Rand Fin. Corp. v. Callister, 13 Bankr. Ct. Dec. (CRR) 21 (10th Cir. 1984).

superpriority, in turn, might preempt interim fees, it would jeopardize the further provision of services. The administrators might mutiny. . . . They might cut corners They might demand exorbitant retainers at the beginning of each case: but for most debtors this either would be impossible or would decrease their chances for rehabilitation.¹⁰⁵

This concern for paying the lawyers gave rise to an extraordinary rule of law:

Section 507(b) gives the superpriority precedence over claims allowed under 507(a), or in other words, over claims allowed under 503(b). Fees, however, may be allowed under 330 and 331. When allowed under these provisions, instead of 503(b)(2), they are not subject to the regimen of 507. Moreover . . . fees are not only allowed but also payable under 331. Section 507(b), in contrast, is silent respecting payment. This gives a de facto preeminence to fees.¹⁰⁶

In other words, attorneys who receive interim compensation under section 331 do not have to give it back if, later, the trustee incurs section 507(b) liabilities by dissipating the collateral. Payment is deemed final and irreversible. This is so even though the secured creditors' claim for compensation under section 507(b) expressly outranks the lawyers' administrative priority under section 507(a)(1).

The scope of this ruling is clouded by the posture in which it was made. In *Callister*, a large bankrupt estate clearly existed, so that it was reasonable to expect that both the secured creditor's 507(b) claim and the attorneys' administrative claims could be paid.¹⁰⁷ It is not certain that Mabey would have allowed an invasion of collateral without the aid of section 506(c) if no unencumbered assets existed to pay the secured creditors.¹⁰⁸ In addition, when the U.S. Court of Appeals for the Tenth Cir-

105. *Id.* at 535 (citations omitted). That large retainers up front are possible under the Bankruptcy Code is a highly dubious assumption. Any retainer paid prior to bankruptcy is property of the estate and must be returned. 11 U.S.C. § 542(a). Any retainer paid after the petition is simply interim compensation under § 331, subject to whatever priorities attend there. *In re NBI, Inc.*, 129 B.R. 212, 224-26 (Bankr. D. Colo. 1991) (Cordova, J.).

Surprisingly, bankruptcy courts anxious to see attorneys paid in overencumbered cases have allowed large prepetition retainers to displace § 331. These cases are criticized in Lester Brickman & Jonathan Klein, *Use of Advance Fee Attorney Retainer Agreements in Bankruptcy: Another Special Law for Lawyers?*, 43 S.C. L. REV. (forthcoming summer 1992).

106. *Callister*, 15 B.R. at 534-35 n.38a (citation omitted).

107. *Id.* at 524-25. The secured creditor's superpriority amounted to \$29,868. *Id.* at 534. The facts state that there was \$332,122 in unencumbered assets on hand. *Id.* at 523 n.7 (schedules listed \$657,127 in secured claims and \$980,249 in total assets).

108. Judge Mabey states that interim compensation is not absolutely required in the face of inadequate collateral for the secured creditors:

Section 331 says that fees "may" be paid on an interim basis. There is a presump-

cuit dismissed the appeal from Judge Mabey's decision, it noted that interim allowances can always be called back, and for that reason the secured creditor could not appeal from the interim award as a jurisdictional matter.¹⁰⁹ This implies that it was open for Judge Mabey to change his mind and force the attorneys to give back their fees if the unencumbered assets of the estate ran out.

Most subsequent authorities have scorned Judge Mabey's dictum against attorney give-backs and instead have ruled that interim compensation may be permitted only if it appears the estate will be large enough to protect the secured creditors *and* cover the attorneys' fees;¹¹⁰ but if that estimate should be wrong, the attorneys and other parties receiving interim compensation will have to return their money to the estate so that senior priorities can be honored.¹¹¹

Other cases have simply proclaimed *Callister* in error. In *General Electric Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*,¹¹² for instance, the U.S. Court of Appeals for the Second Circuit reversed an oral opinion by District Judge Broderick, who had used sections 330 and 331 to justify paying interim fees to the lawyers at a time

tion, for the reasons outlined above, that they will be paid notwithstanding the existence of a superpriority. . . . But it is rebuttable under appropriate circumstances. These circumstances, however, are not present in this case.

Id. at 535 (citations omitted). This language could be read to mean that interim compensation is appropriate only if the bankrupt estate is large enough to pay both the secured creditors and the attorneys and other § 331 claimants.

109. *Callister v. Ingersoll-Rand Fin. Corp. (In re Callister)*, 673 F.2d 305, 307 (10th Cir. 1982) (per curiam), *aff'd*, 13 Bankr. Ct. Dec. (CRR) 21 (10th Cir. 1984).

110. See, e.g., *In re Ridgmont Apartment Assocs.*, 95 B.R. 247, 249-50 (Bankr. N.D. Ga. 1989) (Drake, J.); *In re IML Freight, Inc.*, 52 B.R. 124, 139 (Bankr. D. Utah 1985) (Clark, J.) (no interim compensation if attorneys would thereby receive more than other administrative claimants); *In re American Resources Mgmt. Corp.*, 51 B.R. 713, 719 (Bankr. D. Utah 1985). One case that does so is *In re Energy Cooperative, Inc.*, 55 B.R. 957 (Bankr. N.D. Ill. 1985) (Hertz, J.), but a close reading of that case does not reveal how unencumbered assets existed to justify interim compensation. The secured creditors claimed \$294 million but the firm had only \$271 million in assets. *Id.* at 960. The secured creditors also complained that there were no unencumbered assets left in the estate with which to pay the lawyers. *Id.* at 961. Without explanation, Judge Hertz proclaimed that \$29 million was available to pay the attorneys. See *id.* at 968. The court did not rule on whether this sum was encumbered, as the secured creditors claimed.

111. *In re Precast Structures, Inc.*, 122 B.R. 304, 306 (Bankr. S.D. Tex. 1990) (Clark, J.) ("Such an interim award is subject to adjustment at the time of Application for Final Approval of Fees, if it is later determined that the fees were incorrectly awarded"); *Energy Coop.*, 55 B.R. at 967 ("[A]n inaccurate determination will not ultimately harm any claimholder in light of the fact that fees improvidently granted will be returned to the estate for disbursement to such a claimholder."); *In re American Int'l Airways, Inc.*, 47 B.R. 716, 722 (Bankr. E.D. Pa. 1985) (King, J.).

112. 739 F.2d 73 (2d Cir. 1984) (Van Graafeiland, J.).

when no unencumbered assets remained in the bankrupt estate.¹¹³ The appeals court rejected this interpretation of interim compensation and stated that, if secured creditors are to pay for the trustee's lawyers, such awards must be justified under section 506(c).¹¹⁴

Only one case endorses *Callister* in its most raffish form. Judge Letitia Clark has read *Callister* as a case that "allowed payment of interim fees even where there are no unencumbered assets available in the estate,"¹¹⁵ a statement that captures the dicta but not the facts of the case. But Judge Clark went on to emphasize that the secured creditor before her had sufficient other assets for adequate protection of its security interest, so that the use of cash collateral was appropriate for ordinary expenses of the estate.¹¹⁶ Hence, like Judge Mabey's in *Callister*, Judge Clark's statement is mere dictum.

When all is said and done, however, something powerful can be said in support of *Callister*'s strong position in favor of interim compensation without fear of give-backs. Attorneys and accountants are not the only parties who receive interim distributions. Whenever a supplier dealing with a debtor-in-possession or trustee asks for cash up front in exchange for goods or services, the supplier receives an interim distribution just as surely as a lawyer or an accountant. True, attorneys are paid under Bankruptcy Code section 331, while suppliers probably obtain their cash under section 363(c)(1).¹¹⁷ Either way, cash is being distributed before a

113. Appellants' Joint Appendix at A8, A9, *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73 (2d Cir. 1984) (No. 83-5044) (transcript of oral opinion by District Court Judge Broderick.).

114. *General Elec.*, 739 F.2d at 76-77; see also *In re Chips 'n Twigs, Inc.*, 58 B.R. 109, 111 (Bankr. E.D. Pa. 1986) (Goldhaber, J.) ("[I]nterim compensation cannot be paid from property of the estate to the extent that the property is encumbered by a creditor's security interest."); *In re Colter, Inc.*, 53 B.R. 958, 960 (Bankr. D. Colo. 1985) (McGrath, J.) (attorneys' fees "are inferior and must be recaptured" to satisfy the secured creditors). It is not clear that the Second Circuit would prohibit an award under § 331 when it appears likely that the estate will be large enough to make secured creditors whole and pay all administrative claimants. One bankruptcy judge has assumed that such a prohibition was intended. *Energy Coop.*, 55 B.R. at 967.

115. *In re Precast Structures, Inc.*, 122 B.R. 304, 305 (Bankr. S.D. Tex. 1990).

116. *Id.* Readers should distinguish between (1) using cash collateral for the trustee's attorneys when adequate protection exists; (2) using cash collateral when adequate protection does not exist and the attorneys cannot bring their services under § 506(c); and (3) using unencumbered assets of the estate when the secured creditor has been denied adequate protection for some unrelated reason and is now looking to the unencumbered assets to cover its § 507(b) superpriority. The latter two propositions should be considered contrary to the Bankruptcy Code. The first, however, is totally legitimate. See *infra* notes 174-200 and accompanying text.

117. 11 U.S.C. § 363(c)(1) (1988). This section provides:

If the business of the debtor is authorized to be operated . . . and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease

plan is confirmed, or before liquidation dividends are issued. The 507(a)(1) priority encompasses both attorney distributions¹¹⁸ and ordinary-course distributions.¹¹⁹ If, between the time the supplier receives cash¹²⁰ and the end of the proceeding, all unencumbered assets have disappeared, so that there is a shortfall with respect to the claims of other administrative creditors or a secured creditor's superpriority claim under section 507(b), then, under the anti-*Callister* line of reasoning, all suppliers would be subject to give-backs if a secured creditor has a claim under section 507(b) for failed adequate protection.¹²¹ Nothing in section 363(c)(1) repeals the priorities in section 507(b);¹²² this fault is also the reason section 331 (pertaining only to the trustee and her professionals) does not overrule the priorities in section 507(b). In other words, the argument that attacks *Callister* turns back upon ordinary-course transactions and holds them subject to recall, if necessary to vindicate the Bankruptcy Code's priority system.

That ordinary-course transactions by a trustee are subject to call-back is unthinkable. Undoubtedly the heavy weight of pragmatic necessity will dictate that attorneys have to give back their fees, but other suppliers of ordinary-course goods and services do not have to give back cash demanded and received. Yet if the logic of the anti-*Callister* cases requires the call-back of *all* parties encompassed by the administrative

of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

Id.

118. Section 331 refers to the standards of § 330, which governs noninterim payment to professionals. *See id.* § 330. Section 503(b)(2) allows reimbursement for compensation under § 330(a). *See id.* § 503(b)(2). And § 507(a)(1) gives priority to any claim under § 503(b). *See id.* § 507(a)(1). Therefore, any attorney who works on credit—or who works for cash but is made to give back her fee—has a priority under § 507(a)(1). *See In re Tri-County Water Ass'n*, 91 B.R. 547, 549 (Bankr. D.S.D. 1988) (Hoyt, J.).

119. Section 503(b) "includes" ordinary course matters like salaries and services. 11 U.S.C. § 503(b). Therefore, credit obtained in the ordinary-course of business (but not paid) most likely would be entitled to an administrative priority. *See id.* § 364(a) (trustee may obtain ordinary course credit "allowable under section 503(b)(1)"). Section 507(a)(1) invokes section 503(b). Consequently, ordinary-course credit (and claims arising from any forced give-backs of cash) is entitled to administrative priority, just as attorney claims are.

120. Cash, in this context, means *unencumbered* cash. If the cash is cash collateral, and if the Bankruptcy Code has been followed, then the secured creditor who previously owned the cash has either consented to its use and waived its lien, or it has received replacement collateral by way of adequate protection. *See* 11 U.S.C. § 362(c).

121. *See id.* § 726(b) ("Payment on claims of a kind specified in paragraph (1) . . . of section 507(a) of this title . . . shall be made pro rata among claims of the kind specified in [that] particular paragraph . . .").

122. *But see id.* § 364(c)(1) (providing that trustee may obtain credit by promising prospective lenders a priority higher than that provided by § 507(b)).

priority described in section 503(b),¹²³ then *Callister* seems much better law than is usually conceded.

The only argument I can think of to distinguish professionals from ordinary-course suppliers is that the title (though not the text)¹²⁴ of section 331 refers to "interim" compensation, whereas no such word appears in section 363(c)(1). "Interim" connotes temporary or provisional.¹²⁵ Perhaps the use of this word in the title of section 330 serves to repeal the notion of "final payment" for lawyers and other professionals, though not for ordinary-course suppliers. But this argument is not the strongest peg on which to hang the hat of practical necessity, no matter how feather-light such a hat may be. It is still true that ordinary-course transactions are interim payments of an administrative priority. Secured creditors who have lost their adequate protection are supposed to outrank administrative claimants, and it is a fundamental notion of subordination that wrongful payments be returned so that pri-

123. By the same logic, if remaining unencumbered assets are less than adequate to pay administrative creditors, then the trustee may not buy *anything* for 100 cents on the dollar, because the supplier would have merely an equal priority to the unpaid administrative claimants. The only exception would be that, when Chapter 11 converts to Chapter 7, the Chapter 7 "burial expenses" do outrank the administrative claims dating back to the Chapter 11 case. *Id.* § 726(b).

Also, in dealing with attorneys' fees, courts have refused to distinguish between attorneys' fees paid in advance of bankruptcy (retainers) and interim compensation sought after the work is done. *See In re Tri-County Water Ass'n*, 91 B.R. 547, 550-51 (Bankr. D.S.D. 1988) (Hoyt, J.). If this rule applies to attorneys, it ought to apply equally to suppliers who pay cash.

124. Section 331 is captioned: "Interim compensation." *See* 11 U.S.C. § 331 (1988). The Uniform Commercial Code expressly makes section captions part of the law. U.C.C. § 1-109 (1978). Under federal law, section titles do not have this status. According to Justice Murphy,

headings and titles are not meant to take the place of the detailed provisions of the text. Nor are they necessarily designed to be a reference guide or a synopsis. Where the text is complicated and prolific, headings and titles can do no more than indicate the provisions in a most general manner; to attempt to refer to each specific provisions would often be ungainly as well as useless. As a result, matters in the text which deviate from those falling within the general pattern are frequently unreflected in the headings and titles. Factors of this type have led to the wise rule that the title of a statute and the heading of a section cannot limit the plain meaning of the text. For interpretative purposes, they are of use only when they shed light on some ambiguous word or phrase. They are but tools available for the resolution of a doubt. But they cannot undo or limit that which the text makes plain.

Brotherhood of R.R. Trainmen v. Baltimore & O.R.R., 331 U.S. 519, 528-29 (1947) (citations omitted); *see also* *Scarborough v. Office of Personnel Management*, 723 F.2d 801, 811 (11th Cir. 1984) (Clark, J.) ("[R]eliance upon headings to determine the meaning of a statute is not a favored method of statutory construction."); *Public Serv. Co. v. New Hampshire (In re Pub. Serv. Co.)*, 108 B.R. 854, 884 (Bankr. D.N.H. 1989) (Yacos, J.) (Case law "suggests that titles cannot contradict the meaning of clear text."). *But see* *Mead Corp. v. Tilley*, 490 U.S. 714, 723 (1989) (giving weight to statute heading when text was ambiguous).

125. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE AMERICAN LANGUAGE 1179 (1976) (defining "interim" as "temporary; provisional").

orities might be vindicated.¹²⁶ Accordingly, it must be said that the distinction between paying lawyers and paying other ordinary-course suppliers is based more on intuitive truths than on Code-based principles.

To summarize, this part of the Article has discussed a theory under which secured creditors could be made to pay the expenses of bankruptcy administration, even though the expenses did not benefit the secured creditor within the meaning of section 506(c). The theory holds that interim payments to professionals are final. Thus, if adequate protection of security interests fail, the remedial superpriority under section 507(b), which is supposed to outrank the administrative priority of section 507(a)(1), cannot have its effect because the lawyers have already tapped the estate dry through interim compensation. Through this indirect method, the secured creditors can be made to pay the ordinary expenses of bankruptcy administration.

The next section discusses a slightly different technique for achieving the same end: postpetition loan agreements in which property of the estate is pledged to lenders in exchange for which the lender promises to pay the ordinary expenses of bankruptcy directly to the supplier, without any loan proceeds passing through the bankrupt estate.

3. Carve-Out Orders

When a secured creditor has soaked up all the assets of a debtor, a bankruptcy judge needs to find a way to pay the lawyers if the bankruptcy proceeding is to continue. We shall soon see the extent to which section 506(c) might be used to pay the attorneys.¹²⁷ But suppose a bankruptcy judge finds herself in a circuit that takes a narrow view of section 506(c)'s scope. For instance, the United States Court of Appeals for the Second Circuit has taken a very narrow view of section 506(c), holding that attorney services to the debtor-in-possession do not benefit secured creditors when a bankrupt estate with unencumbered assets devolves into an estate with all assets encumbered.¹²⁸ The same case also expressly disapproves of *Callister*.¹²⁹ Does this twin ruling mean that the

126. Complicating matters is the fact that no one can be a holder in due course of checks—or, under analogous common law, cash—issued in a judicial proceeding. U.C.C. § 3-302(3)(a) (1978) (holder is not a holder in due course “by purchase of [a negotiable instrument] at judicial sale”); see also *id.* § 3-302 cmt. 3 (“The provision applies to a . . . sale in bankruptcy . . .”). Hence, it is hard for a supplier to claim that it takes checks or even cash free and clear of the obligation to return it if needed to cover the claims of senior creditors.

127. See *infra* text accompanying notes 244-309.

128. *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 75-77 (2d Cir. 1984) (Van Graafeiland, J.). For a discussion of the facts of this case, see *infra* notes 244-53 and accompanying text.

129. *General Elec.*, 739 F.2d at 75.

assets of the firm must be abandoned to the secured creditor for foreclosure under state law?

In *In re Connecticut Printers, Inc.*¹³⁰ Judge Krechevsky thought he found a way to protect the trustee's lawyers from secured creditors. He achieved this goal by means of section 364(c), which governs postpetition credit. Section 364(c) states:

If the trustee is unable to obtain unsecured credit . . . as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt—

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.¹³¹

Under this provision, the bankruptcy trustee in *Connecticut Printers* pledged all the debtor's unencumbered assets to a financing bank in exchange for the bank's promise to pay the trustee and her attorneys. The theory seemed to be that if unencumbered assets were laundered through a financing bank, those assets could no longer be reached by secured creditors with a higher priority than the trustee. If this scheme—called a “carve-out”¹³²—works, a trustee can preserve her fee and dissipate collateral without fear of subordination to secured creditors deprived of their adequate protection.¹³³

There is one weakness in this scheme. If the financing bank takes a lien on unencumbered assets of the estate, the dollars it advances are not necessarily encumbered. Therefore, if the trustee and her attorney take these loan proceeds, they take property of the estate and are in precisely the same position as the lawyers in the anti-*Callister* cases discussed above.¹³⁴ They must give back their fees if necessary to make secured creditors whole, because secured creditors whose adequate protection has failed have, under section 507(b), a higher priority than the trustee.¹³⁵

130. No. 2-90-00771 (Bankr. D. Conn. June 8, 1990) para. 12 (Stipulation and Agreed Order Providing for Interim Use of Cash Collateral) (Chapter 11).

131. 11 U.S.C. § 364(c) (1988) (emphasis added).

132. Stephen A. Stripp, *Balancing of Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11*, 21 SETON HALL L. REV. 562, 579 (1991).

133. According to Judge Stripp, these carve-outs are also often supplemented with an order that the debtor-in-possession or trustee may never charge § 506(c) expenses against the carve-out lender. *Id.* at 578-79. Judge Stripp thinks that such orders ought to be illegal and ignored later in the bankruptcy proceeding, if a judge accidentally signs such a waiver. *See id.*

134. *See supra* text accompanying notes 110-11.

135. *See In re Precast Structures, Inc.*, 122 B.R. 304, 305-06 (Bankr. S.D. Tex. 1990)

Section 364(c)(1) explicitly provides that the financing bank's collateral is immune from the claims of other secured creditors whose adequate protection has failed. But how can the loan proceeds be protected so the trustee may obtain her fee in violation of the Bankruptcy Code?

Judge Krechevsky's solution was to deem the loan proceeds cash collateral of the bank, unless drawn upon by the trustee and his professionals for their fees.¹³⁶ Thus, if the trustee did not draw on this account, the financing bank still owned the loan proceeds, which never entered the bankrupt estate. Hence, they were shielded from a disappointed secured creditor's superpriority under section 507(b). Meanwhile, the trustee and his professionals, who could not have tapped the unencumbered assets directly for their fees, were able to get paid free and clear of the senior claims of secured creditors who were denied their adequate protection.

The flaw in this scheme is its premise that when the bank pays the trustee directly, the loan proceeds never enter the bankrupt estate. When the trustee exercises her power to take money from the account, she must do so pursuant to a fiduciary duty owed to the general creditors. Any secured creditor deprived of adequate protection is a general creditor to whom this duty is owed. Therefore, it should follow that money taken by the trustee is for the use and benefit of the bankrupt estate and subject to the priorities established by the Bankruptcy Code. These priorities in turn dictate the rule of return established by the anti-*Callister* cases.

If Judge Krechevsky's order stands up on appeal to the Second Circuit Court of Appeals (which hardly seems possible),¹³⁷ the trustee will

(Clark, J.); *In re Energy Coop., Inc.*, 55 B.R. 957, 967 (Bankr. N.D. Ill. 1985) (Hertz, J.); *In re American Int'l Airways, Inc.*, 47 B.R. 716, 722 (Bankr. E.D. Pa. 1985) (King, J.); see *supra* text accompanying notes 117-22.

136. *In re Connecticut Printers, Inc.*, No. 2-90-00771 (Bankr. D. Conn. June 8, 1990) para. 12 (Stipulation and Agreed Order Providing for Interim Use of Cash Collateral). According to this Order:

Bank shall establish an account in its name entitled "Connecticut Printers Chapter 11 Account" (the "Chapter 11 Account") into which it will deposit the first \$200,000 of Cash Collateral paid over to it . . . to the extent such Cash Collateral represents proceeds of Accounts arising from the shipment by Debtor of goods after the Petition Date. The money held in the Chapter 11 account shall be subject to the lien and security interests granted to the Bank pursuant to [earlier orders] but Bank shall release from the Chapter 11 Account any amounts awarded to the Trustee, the professional people employed by him and the fees of the United States Trustee as above provided.

Id.

137. The governing precedent, *General Electric Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 76-77 (2d Cir. 1984), does not deal with postpetition credit carve-out orders, but it does reveal tremendous hostility to the idea that secured creditors can be made to bear the expenses of ordinary bankruptcy administration. Since

have developed an ingenious way of paying her lawyers and herself when assets are insufficient to reimburse the secured creditors.¹³⁸ If that scheme succeeds, then, even though section 506(c) does not allow the trustee to charge his expenses to a secured creditor, and even though the secured creditor might outrank the trustee's own claim for compensation, no unencumbered assets will remain in the estate against which the secured creditor's superpriority might apply.

4. Summary

The last three subsections of this Article have discussed theories whereby a trustee might charge expenses to the secured creditors without any reliance on section 506(c) and its requirement that secured creditors be "benefited" by such expenditures. The first of these ideas, disencumbering cash proceeds under section 552(b), does require, at least according to the legislative history, that the expenditures be related to generating the cash proceeds. This requirement probably means that section 552(b) simply replicates the standards of section 506(c). The second idea is that interim distributions to attorneys and other professionals are "final payments" that cannot be recalled if the bankrupt estate exhausts itself and if the secured creditors' adequate protection has failed. As we have seen, the case law weighs heavily against a final payment rule with regard to lawyers. Finally, carve-out orders might be a way to launder estate property through a superpriority postpetition lender so that, if adequate protection fails, payments to the lawyers and other professionals (made directly by the lender to the professionals) are immunized against the secured creditors' higher priority. This last idea is conceptually flawed because any withdrawals by the professionals are withdrawals pursuant to a fiduciary duty not to defeat the priorities of the Bankruptcy Code. Hence, it is unlikely that any theory separate from section 506(c) should work to impose the expenses of bankruptcy administration on secured creditors.

Given that section 506(c) governs the conditions under which se-

Judge Krechevsky's subterfuge of the Bankruptcy Code is transparent, it is hard to believe that such an order would survive appellate scrutiny.

138. Furthermore, the financing bank may be substantially immune from reversal on appeal. See 11 U.S.C. § 364(e) (1988). The exact scope of this immunity is in bitter dispute. Compare *In re EDC Holding Co.*, 676 F.2d 945, 947-48 (7th Cir. 1982) (Posner, J.) (lender not entitled to appeal-free security interest when violation of Bankruptcy Code is patent) with *Shapiro v. Saybrook Mfg. Co.* (*In re Saybrook Mfg. Co.*), 127 B.R. 494, 496, 499-500 (M.D. Ga. 1991) (Fitzpatrick, J.) (lender immune even though postpetition collateral given for prepetition unsecured claims). The travesty of justice that § 364(e) represents is well treated in Charles J. Tabb, *Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma*, 50 OHIO ST. L.J. 109, 116-35 (1989).

cured creditors can be made to bear the expenses of the bankruptcy trustee, the next section of this Article shows how a bankruptcy court's valuation of a secured creditor's collateral affects the extent to which a trustee may use section 506(c) to charge a secured creditor with administrative expense.

II. COLLATERAL VALUE AND 506(C) EXPENSES

A. *The Definition of Value*

Fundamental to the Bankruptcy Code is the need to place an assessed valuation on collateral in the possession of the bankruptcy trustee.¹³⁹ According to section 506(a):

An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.¹⁴⁰

The meaning of section 506(a) for undersecured creditors—and section 506(c) is relevant *only* for undersecured creditors¹⁴¹—is that their claims are subdivided into their wholly secured and wholly unsecured parts. That is, the undersecured creditor is made the owner of two unrelated claims in bankruptcy—one secured and the other unsecured. To achieve this subdivision, a bankruptcy judge must place a value on the collateral. Yet, section 506(a) does not clearly state how this valuation should be made. Indeed, the legislative history urges judges to make the rules for valuation on a case-by-case basis.¹⁴² Accordingly, there are a great

139. For a description of the legal significance of valuations in bankruptcy, see John B. Butler, III, *Valuation of Secured Claims Under 11 U.S.C. 506(a)*, 89 COM. L.J. 342, 345 (1984); David Gray Carlson, *Secured Creditors and the Eely Character of Valuations in Bankruptcy*, 41 AM. U. L. REV. 63, 63-70 (1991); Chaim J. Fortgang & Thomas M. Mayer, *Valuations in Bankruptcy*, 32 UCLA L. REV. 1061, *passim* (1985); James F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 COM. L.J. 18, 25-28 (1987).

140. 11 U.S.C. § 506(a) (1988).

141. See *supra* text accompanying notes 12-39.

142. "Value" does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it always imply a full going-concern value. Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case." H.R. REP. NO. 595, 95th Cong., 1st Sess. 356 (1977); see S. REP. NO. 989, 95th Cong., 2d Sess. 54 (1978).

many theories about what valuation entails.¹⁴³

One important aspect of valuation theory collides with the meaning of section 506(c). This theoretical aspect stems from the fact that the value of collateral to the buyer differs from its value to the seller by virtue of the transaction costs required to realize a sale. To be sure, in the real world, these costs—sales expense and maintenance pending sale—are ultimately borne jointly by the buyer and seller (at least where supply and demand are both elastic). Either the seller covers them and charges the buyer what the market will bear, or the buyer covers them, in which case the buyer's demand for the item falls accordingly.¹⁴⁴ But these are hypothetical transaction costs, which have not yet been, and may never be,

143. These theories are reviewed in Carlson, *supra* note 139, at 70-87.

144. This is not to say that the equilibrium price will be the same, no matter who bears the transaction costs. Because of the shape of the supply and demand curves, transaction costs are borne at different levels of efficiency. For example, suppose the supply curve faced by the producer is defined as $P = 5 + 1.1Q$. The demand curve faced by the consumer is $Q = 100 - 3P$. In a competitive market, these curves produce an equilibrium price of

$$P = 5 + 1.1[100 - 3P]$$

$$P = 26.74$$

Total quantity produced is

$$Q = 100 - 3[5 + 1.1Q]$$

$$Q = 19.7674$$

Suppose a transaction cost of 10 is added and is borne by the seller. This changes the supply curve to $P = 15 + 1.1Q$. The demand curve is unchanged, but the supply is now more expensive. Less of it is demanded. In such a case:

$$P = 15 + 1.1[100 - 3P] = 29.06$$

$$Q = 100 - 3[15 + 1.1Q] = 12.79$$

If the same transaction cost is borne by the consumer, then the original supply curve is restored, but the entire demand curve shifts downward: $Q = 90 - 3P$

$$P = 5 + 1.1[90 - 3P] = 24.18$$

$$Q = 90 - 3[5 + 1.1Q] = 17.44$$

On these numbers, total gain to society (the producer's economic rents plus consumer surplus) was \$938.9515 before transaction costs. If the producer bears transaction costs, the total gain falls to \$543.575. If the consumer bears transaction costs, the total gain increases to \$741.20. Hence, given the stipulated supply and demand curves, comparative efficiencies favor the consumer bearing the transaction costs. (Total gain—economic rents plus consumer surplus—can be calculated as follows:

$$\frac{Q[x - y]}{2}$$

where x is the conjunction of the ordinate and the supply curve (100 or 90) and y is the conjunction of the demand curve and the ordinate (15 or 5). Since, on our numbers, $(x - y) = 85$, the above formula can be reduced to $42.5Q$.)

incurred. Whether these hypothetical costs are deducted affects the size of a secured claim in bankruptcy.

Bankruptcy judges should be aware of the relation between market value and expected transaction costs, because it is too easy to modulate between choosing a price that the buyer will pay (before transaction costs are covered by the seller) or the price the seller will receive (after transaction costs are covered). Thus, we are faced not only with a terminological confusion, but also with a substantive property entitlement confusion when presented with the notion of the "value" of collateral: should value be *ex post* or *ex ante* transaction costs?

There is no simple answer to this question. Some courts have taken the view that value should be *ex post* transaction costs because value should represent what the secured creditor takes out of a hypothetical foreclosure sale.¹⁴⁵ This rule comports with a common sort of imaginary exercise: the secured creditor is entitled to whatever she would have received if there were no bankruptcy at all.¹⁴⁶ But under such a rule, collateral will *always* have an equity cushion at the time of valuation since the hypothetical buyer will always pay in more than the secured creditor hypothetically takes out. For example, suppose a bankruptcy court thinks that, if there were no bankruptcy, a buyer at a foreclosure sale would pay \$100 for collateral, but the seller would bear transaction costs of \$5. Meanwhile, the secured creditor claims \$300. Although the collateral is substantially overencumbered, the bankrupt estate has a positive equity in this collateral. The secured claim would be set at \$95 and debtor equity would be worth \$5.¹⁴⁷

If collateral always has extra value beyond the amount of the secured claim—the difference between what a buyer would pay in and what the secured creditor would take out—one part of the Bankruptcy Code is threatened with superfluity. According to section 362(d)(2)(a), a secured creditor is entitled to have bankruptcy's automatic stay lifted if the debtor has no equity in the collateral.¹⁴⁸ If the definition of value is such that debtor equity always exists, then section 362(d)(2)(a) is wrongfully deprived of its necessity.

It is a prime rule of statutory construction that no statutory lan-

145. See, e.g., *In re Boring*, 91 B.R. 791, 795 (Bankr. S.D. Ohio 1988) (Coles, J.) (citing and dismissing contrary authority).

146. See Carlson, *supra* note 139, at 70-75.

147. The secured creditor also would have a separate unsecured deficit claim of \$205. See 11 U.S.C. § 506(a) (1988).

148. *Id.* § 362(d)(2)(A). In addition, the property must not be necessary for an effective reorganization. *Id.* § 362(d)(2)(B). If either premise is true, the secured creditor may not obtain relief from the automatic stay.

guage in the Bankruptcy Code should be rendered useless. Thus, in *United Savings Ass'n v. Timbers of Inwood Forest Associates*,¹⁴⁹ Justice Scalia denied postpetition interest to undersecured creditors as part of their right to adequate protection because, otherwise, section 362(d)(2) would have been rendered superfluous. Arguing from superfluity is always a dangerous strategy—it can be defeated merely by thinking up some use for the statute. In *Timbers*, if secured parties are paid opportunity costs as part of adequate protection, a secured creditor still has the incentive to use section 362(d)(2) whenever it believes the court's valuation is too low or if the interest compensation is inadequate.¹⁵⁰ Nevertheless, *Timbers* undoubtedly stands for the efficacy of such arguments in general. Thus, a definition of value that always guarantees a debtor equity might be impermissible because it reads section 362(d)(2)(a) out of the Bankruptcy Code.¹⁵¹

To resolve the dilemma posed by deducting hypothetical transaction costs from the value of collateral, Judge Smallenberger was forced in *In re Skains*¹⁵² to rule that the secured creditor was entitled to have the automatic stay lifted even if debtor equity exists. Said Judge Smallenberger: "The law has never meant that there must be absolutely no equity in property, because the secured creditor needs some cushion in order to pay the costs of foreclosure in state court."¹⁵³ Hence, Judge Smallenberger saved the definition of value *ex post* transaction costs, but only at the expense of re-writing section 362(d)(2)(A) to mean that the stay can be lifted *even if* debtor equity exists.

B. Valuation Ex Post Transaction Costs and Section 506(c)

Suppose that a secured creditor's collateral is valued as the amount the secured creditor will realize after hypothetical transaction costs are deducted. What happens if the trustee really does incur transaction costs that exceed these estimates?

If the trustee spent precisely what the secured creditor would have

149. 484 U.S. 365 (1988).

150. Carlson, *supra* note 1, at 608-09.

151. *In re Felten*, 95 B.R. 629 (Bankr. N.D. Iowa 1988) (Melloy, J.). In *Felten*, the debtor argued that the secured creditor's collateral should be valued according to what a secured creditor would get (after transaction costs) at a foreclosure sale. The court rejected this standard and instead chose the "fair market value," which is "the price which a willing seller under no compulsion to sell and a willing buyer under no compulsion to buy would agree upon." *Id.* at 630 (quoting *In re Courtright*, 57 B.R. 495, 496 (Bankr. D. Or. 1986)). By this, the court seemed to mean a standard based on what a buyer pays in, not on what a seller clears after transaction costs.

152. 46 B.R. 500 (Bankr. W.D. La. 1984).

153. *Id.* at 502.

spent, no problem arises. Suppose, for example, that a court estimates a buyer would pay \$100 for collateral, but transaction costs are \$5. The secured creditor's maximum secured claim under section 506(a) is therefore \$95. Suppose further that, in a subsequent sale free and clear of liens,¹⁵⁴ the trustee obtains a bid of \$100 and does spend \$5 marketing the collateral. On these numbers, the secured creditor gets \$95 in cash proceeds, and the trustee may take the sales expense from the debtor equity in the collateral, without the need to invade the secured claim under section 506(c). In such a scenario, no conflicts of interest arise. Theory and practice are happily in unison.

Suppose, instead, that the costs incurred by the trustee exceed the hypothetical transaction costs of the secured creditor. Say she had to spend \$12 to liquidate collateral. Without question, the trustee can charge \$5 of this expense against the debtor's equity of \$5. For this charge, section 506(c) is not even needed. But can the trustee also invade the secured creditor's principal under section 506(c) and reduce the secured creditor's take by another \$7? Under these circumstances, secured creditors are apt to argue that they were not "benefited" by the trustee's overpriced services, within the meaning of section 506(c).

The answer to this question should depend on the *reason* the hypothetical and actual expenditures did not match. What follows are some reasons for the disharmony and their effects on the trustee's entitlement under section 506(c).

1. Error in the Valuation

One possible reason the trustee might spend more than the original valuation is that the estimate was erroneous. That is, the court or the parties should have foreseen that transaction costs would have been higher than the initial estimate. Should the trustee be able to invade principal under such circumstances?

The answer to this question depends on whether it is generally permissible for courts to adjust 506(a) valuations to account for earlier errors in estimation. Opinion is divided on this question. The weight of authority seems to favor the ability of a court to adjust its valuations from time to time,¹⁵⁵ and so an adjustment based on misestimated trans-

154. See 11 U.S.C. § 363(f)(3) (1988).

155. See David Gray Carlson, *Undersecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral*, 6 BANKR. DEV. J. 253, 258-60 (1989). According to the Congressional Commission on the Bankruptcy Laws of the United States:

The procedures required by the Act in the sale of property of a bankrupt estate have been much criticized for the inordinate administrative detail and expense. The

action costs ought to be possible. Hence, when the trustee spends more than the hypothetical transaction costs that, on hindsight, seem to have been naively underestimated, either the estimate should be readjusted, so that the trustee can reimburse herself from the now-larger debtor equity—without the aid of section 506(c)—or the trustee should be able to recover from the collateral under section 506(c). Under either theory, the secured creditor must bear the expense actually incurred by the trustee.

2. Overexpenditure by the Trustee

A second reason the trustee may have exceeded the expected transaction costs is that the trustee spent more than was necessary. Section 506(c) provides that the trustee can charge secured creditors with only “reasonable” and “necessary” expenses of sale and collateral preservation.¹⁵⁶ Therefore, a finding that part of the trustee’s expenses are “not necessary” would be fatal to the trustee’s claim for expenses. Nevertheless, if the trustee has not been reckless or profligate, an argument exists for allowing the trustee to invade the secured creditor’s principal, on the theory that the trustee’s business judgment ought to be protected.¹⁵⁷

3. Comparative Efficiencies

A third and very potent reason for the cost overrun—and one that contradicts what has just been said—is institutional in nature: secured creditors (at least under the Uniform Commercial Code) often have access to cheap self-help remedies, while a bankruptcy trustee is burdened with many expensive legal formalities. As a result, a bankruptcy trustee is institutionally more likely to spend more to sell collateral than many secured creditors would. But this conclusion is subject to an inherent indeterminacy. Recall that the standard of value is based on imagining what a secured creditor would have realized at state law. On the one hand, this expense could be imagined to be very low, as in the case of a peaceable self-help repossession. On the other hand, if the debtor would have threatened violence, self-help would be impossible; the secured

trustee must ordinarily obtain court approval in the form of an order permitting the sale; creditors must ordinarily be notified of any proposed sale; the property must ordinarily be appraised; the sale must ordinarily be a public sale, and the trustee’s sale is subject to approval or disapproval by the court. Not only are such procedures not conducive to getting the best price, but the expenses frequently consume a substantial part of the proceeds obtained from the sale.

REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess. 16-17 (1973).

156. 11 U.S.C. § 506(c) (1988).

157. *In re AFco Enters., Inc.*, 35 B.R. 512, 517-18 (Bankr. D. Utah 1983) (Clark, J.).

creditor would resort to a replevin action at state law, considerably raising the cost of collecting.¹⁵⁸ None of this is verifiable, since it is all based on the imagination of the judge. Translated into bankruptcy terms, the bankrupt estate is impoverished if the bankruptcy judge fancies the debtor to be polite and deferential to the rights of the secured creditor, and is enriched if the judge views the debtor as a brawling, cheating thug.

Let us suppose that a bankruptcy court decides that, but for the bankruptcy, the secured creditor would have repossessed very cheaply under the self-help provisions of Article 9. Accordingly, if the trustee sells the collateral and incurs 506(c) expenses, she is sure to exceed whatever was hypothesized as part of the definition of value. That is, by force of the definitions, a trustee must exceed the estimated transaction costs of selling the collateral.

Some old cases prohibit invasion of the secured claim by the trustee, under these circumstances.¹⁵⁹ Some modern cases echo this view.¹⁶⁰

158. The expense that *would have been incurred* if there had been no bankruptcy is not a verifiable proposition. It depends entirely on the rules by which hypothetical, nonexistent universes are constructed. See Carlson, *supra* note 139, at 70-75.

159. See *Textile Banking Co. v. Widener*, 265 F.2d 446, 454 (4th Cir. 1959) (Paul, J.) ("the fund may be charged with the actual costs of the sale by the trustee or the cost of enforcing the lien in a State court, whichever is the smaller sum"); *Reconstruction Fin. Corp. v. Rhodes*, 214 F.2d 606, 607 (5th Cir. 1954) (Holmes, J.); *L. Maxcy, Inc. v. Walker*, 119 F.2d 535, 536 (5th Cir.) (Foster, J.), *cert. denied*, 314 U.S. 647 (1941); see Frank R. Kennedy, *An Adversary Proceeding Under the New Bankruptcy Rules, With Special Reference to a Sale Free of Liens*, 79 COM. L.J. 425, 438-40 (1974). These cases all dealt with trustee sales in which the trustee spent more than expected. To be distinguished are cases in which the trustee attempts to charge *preservation* expenses to the secured creditor under § 506(c). These preservation cases are discussed *infra* notes 244-309 and accompanying text.

160. Thus, in *In re Wyckoff*, 52 B.R. 164 (Bankr. W.D. Mich. 1985) (Nims, J.), a trustee sought to recover storage fees under § 506(c), but was denied. Judge Nims remarked,

If not for the bankruptcy, [the secured creditor] could have disposed of its collateral much sooner and at a total cost that would have enabled it to realize the amount of its claim in full. Such costs may have included a small storage fee as well as costs of sale, but clearly it would not have found it necessary to store the inventory for four months at a cost exceeding \$1,200.00 per month.

Id. at 168; see also *C.I.T. Corp. v. A & A Printing, Inc.*, 70 B.R. 878, 881 (M.D.N.C. 1987) (Bullock, J.) (holding that rental and security expenses could not be charged to the secured creditors); *In re Richards Pontiac, Inc.*, 24 B.R. 758, 760-61 (Bankr. E.D.N.Y. 1982) (Hall, J.) (stating that the lienholders would be permitted to demonstrate that they could have recovered their collateral from the debtor more cheaply without the trustee having interceded); *First Nat'l Bank v. Taylor (In re Modern Mix, Inc.)*, 18 B.R. 746, 749 (Bankr. S.D. Ala. 1982) (Caffey, J.) (stating that since the secured creditor could have collected the debtor's accounts receivable without expense, the secured creditor was not liable to the trustee for the trustee's expenses incurred in collecting such receivables); *Moister v. Farmers Bank (In re Truitt)*, 15 B.R. 169, 171 (Bankr. N.D. Ga. 1981) (Robinson, J.) (declaring that charges to the general creditors are permissible only to the extent that the service was necessary and benefited the creditors). The *Taylor* case seems particularly confused. In *Taylor* the trustee collected encumbered accounts receivable and wanted to charge the secured creditor for the expense.

These cases have emphasized the requirement in section 506(c) that the expenditure "benefit" the secured creditor.¹⁶¹ That is, since a secured creditor could have foreclosed cheaply under state law, an expensive bankruptcy foreclosure is, by definition, not for the benefit of the secured creditor. According to this view, the trustee is never allowed to invade the secured claim to recover even reasonable expenses of sale. Instead, the trustee, who should have abandoned the collateral to the secured creditor for enforcement under state law, must bear the costs of disposing of the collateral.

We saw earlier that, if valuation is *ex post* transaction costs, then all collateral has debtor equity built in.¹⁶² Under such a definition of value, limiting section 506(c) expenses to what the secured creditor would have spent had there had been no bankruptcy translates into a rule that enforcement expenses may only be recovered out of debtor equity and never out of the collateral needed to support the secured claim of an undersecured creditor. Such a rule essentially reads section 506(c) out of the Bankruptcy Code, because the trustee does not need section 506(c) in order to use the debtor's equity. On the premise that no part of the Bankruptcy Code should be rendered superfluous, the continued vitality of section 506(c) demands the rejection of such cases. Instead, "benefit," within the meaning of section 506(c), should comprehend circumstances when the trustee spent more than the secured creditor would have, if no bankruptcy proceeding existed.

4. Consent

One common rationale for invading the secured claim is that the secured creditor has consented to it. Of course, consent must come from

Mysteriously, the court denied recovery because the secured creditor supposedly could have collected for no expense at all. *Taylor*, 18 B.R. at 749. Thus, the case may be an application of the rule that the trustee may never recover when her efforts exceed in cost what the secured creditor would have incurred.

161. See, e.g., *Dozoryst v. First Fin. Sav. & Loan Ass'n*, 21 B.R. 392, 394 (N.D. Ill. 1982) (Shadur, J.) (trustee must show quantitative benefit, presumably in comparison to what the secured creditor could have realized on its own); *In re Birdsboro Casting Corp.*, 69 B.R. 955, 959 (Bankr. E.D. Pa. 1987) (Fox, J.) ("[D]ebtor's counsel had the burden of showing that the Bank received a benefit from his services—that is, the Bank recovered more than it would have but for those services, or that counsel somehow eliminated expenses that the creditor would otherwise have had to bear.").

162. See *supra* text accompanying note 148. One commentator overlooks this and therefore erroneously thinks that secured parties get a windfall where § 506(c) charges are disallowed. See *Savage, supra* note 13, at 434 ("considerations of fairness would seemingly require that a secured creditor contribute at least what he has been spared by foreclosure in bankruptcy"). This comment pertains only if a certain theory of valuation is presupposed—one in which value is estimated without deducting hypothetical transactions costs.

the secured creditor whose claim is being invaded. The consent of a senior secured creditor who faces no invasion because she enjoys an equity cushion is irrelevant to bind the junior secured creditor who will really foot the bill.¹⁶³

In re Orbitronics, Inc.,¹⁶⁴ is a case in which the court allowed the invasion of the secured claim on a theory of consent.¹⁶⁵ Here the secured creditor wrote a letter authorizing the payment of trustee compensation—not ordinarily chargeable to the secured creditor under section 506(c)¹⁶⁶—from the proceeds of collateral.¹⁶⁷ This was real consent, not low-grade acquiescence or apathy. The former surely must be as rare as the latter is common.

Not surprisingly, trustees are constantly trying to make acquiescence into affirmative consent. With some exceptions,¹⁶⁸ courts usually do not take the bait.¹⁶⁹ Some courts have pointed out quite rightly that consent to retention of collateral by a trustee in general is not the same as consent to any expense the trustee wants to incur.¹⁷⁰ Under the Bankruptcy Code, secured parties are entitled to adequate protection of the security interests, which means protection against invasion of the collateral by the trustee. Hence, consent to foreclosure may mean consent to the sale itself given adequate protection, a version of consent that would

163. *In re Trengse*, 127 B.R. 552, 554-55 (E.D. Pa. 1991) (Pollack, J.). Of course, the senior secured creditor could agree to reduce her claim and hold the junior secured creditor harmless. In such a case, consent is a good theory to apply to § 506(c) expenses, but only to the senior secured creditor. *Id.* at 555 n.3.

164. 254 F. Supp. 400 (E.D. Wis. 1966) (Reynolds, J.).

165. *Id.* at 404-05.

166. *First Nat'l Bank v. B & L Enters., Inc. (In re B & L Enters., Inc.)*, 26 B.R. 220, 223 (Bankr. W.D. Ky. 1982) (trustee's statutory fee under § 326(a) cannot be brought in under § 506(c)).

167. *Orbitronics*, 254 F. Supp. at 402-03.

168. See, e.g., *In re Pioneer Sample Book Co.*, 374 F.2d 953, 961 (3d Cir. 1967) (Hastie, J.) (equating acquiescence with consent); *United States v. Annett Ford, Inc. (In re Annett Ford, Inc.)*, 64 B.R. 946, 947 (D. Neb. 1986) (Beam, C.J.); *In re Hotel Assocs.*, 6 B.R. 108, 109-11 (Bankr. E.D. Pa. 1980) (King, J.) (failure to request relief from the automatic stay and motion for trustee to be appointed in a Chapter 11 case taken as evidence of consent to the trustee's reimbursement under § 506(c)); see Presley, Note, *supra* note 13, at 1110.

169. *Central Bank v. Cascade Hydraulics & Util. Serv., Inc. (In re Cascade Hydraulics & Util. Serv., Inc.)*, 815 F.2d 546, 549 (9th Cir. 1987) (Wright, J.); *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 77 (2d Cir. 1984) (Van Graafeiland, J.) (consent should not be imputed lightly); *United States v. Henderson*, 274 F.2d 419, 421-22 (5th Cir. 1959) (Rives, C.J.) (acquiescence to reorganization was not consent to pay expenses); *Schindler v. Sharak (In re Salzman)*, 83 B.R. 233, 241 (Bankr. S.D.N.Y. 1988) (Schwartzberg, J.) (mere failure to object does not constitute consent); *In re S & S Indus.*, 30 B.R. 395, 398-99 (Bankr. E.D. Mich. 1983) (Brody, J.).

170. *In re Roamer Linen Supply, Inc.*, 30 B.R. 932, 935-37 (Bankr. S.D.N.Y. 1983) (Schwartzberg, J.); Presley, Note, *supra* note 13, at 1110.

negate the use of section 506(c) for reimbursing the trustee. Making the rules depend on secured creditor opposition to bankruptcy jurisdiction—which the Bankruptcy Code clearly permits—simply encourages secured parties to be needlessly obstreperous.¹⁷¹ According to Judge Robert Ginsberg:

Mere cooperation with a debtor or acquiescence in an attempted reorganization is insufficient. The reason for this rule is clear. Creditor cooperation is a significant factor in a successful reorganization. That is particularly true of secured creditor cooperation. To require secured creditors to fight every step of the way in a Chapter 11 case or risk being saddled with all the costs of a failed reorganization effort under 11 U.S.C. § 506(c) would be antithetical to the purposes of Chapter 11. A secured creditor should be encouraged to work with the debtor in the reorganization effort. After all, a successful Chapter 11 case will benefit the debtor, the secured creditor, and the unsecured creditors. However, secured creditor cooperation in the reorganization effort is not the same thing as secured creditor's consent to finance the costs of the reorganization case. Such consent on the part of the secured creditor must clearly appear from the circumstances.¹⁷²

In any case, under the current Bankruptcy Code, the trustee has complete power to foreclose whether the secured creditor consents or not. Therefore, unless the secured creditor knowingly and voluntarily endorses a pattern of specific expenses by the trustee, claims of secured creditor consent should be viewed with great suspicion.¹⁷³

171. See Note, *Allocation of Expenses Incurred in a Bankruptcy Sale Free of Liens*, 53 COLUM. L. REV. 845, 852 (1953) (making this argument under the former Bankruptcy Act).

172. *In re Chicago Lutheran Hosp. Ass'n*, 89 B.R. 719, 730-31 (Bankr. N.D. Ill. 1988) (citations omitted). Judge Ginsberg may have undercut his argument by admitting that reorganizations can "benefit" secured parties, because such benefit is the premise that allows charges under § 506(c). *Id.* at 730. Elsewhere in his opinion, he specifically finds that the secured creditor in question received no "benefit" from the reorganization at hand. *Id.* at 731.

173. One circumstance does seem to signal genuine consent to paying for a trustee. If the secured creditor moves for a trustee at a time when no unencumbered assets exist to pay the trustee, courts reasonably have concluded that the secured creditor must have consented to the trustee's commission as a § 506(c) expense. *In re Bob Grissett Golf Shoppes, Inc.*, 50 B.R. 598, 609 (Bankr. E.D. Va. 1985) (Bostetter, J.), *modified*, 76 B.R. 89 (Bankr. E.D. Va. 1987). *In re AFCO Enterprises, Inc.*, 35 B.R. 512 (Bankr. D. Utah 1983) (Clark, J.), the secured creditor made this motion at a time when there was debtor equity in the property. *Id.* at 513, 517. Later, the collateral deteriorated to such an extent that the secured creditor was undersecured. *Id.* Given the priorities of § 506(c)—the trustee is required to use existing debtor equity before invading the secured claim—consent at a time when there is a cushion should not be consent to invade the secured claim later.

III. SALES EXPENSES VERSUS GOING-CONCERN EXPENSES

A. *Cash Collateral*

A major purpose of this Article is to describe when the expenses of a going concern may be charged to a secured creditor under section 506(c). But before such a description can be meaningful, it is necessary to say a few words about cash collateral in bankruptcy.¹⁷⁴

Whether the underlying collateral is personal property or real property, a secured creditor frequently has a lien on cash proceeds obtained by the debtor.¹⁷⁵ A bankruptcy trustee may wish to use this cash collateral to meet expenses of the estate.¹⁷⁶ These expenses may be either regular administrative expenses, against which secured parties must be adequately protected, or section 506(c) expenses, for which the secured creditor must pay. The rules pertaining to the use of cash collateral differ radically, therefore, depending on the nature of the trustee's expenses.

Consider first a trustee who wishes to use cash collateral for general administrative purposes, not for the purposes described in section 506(c). Bankruptcy Code section 363 describes the power of a trustee to use property generally. Sometimes, use or sale requires court approval. For example, if the trustee wishes to sell property outside of the ordinary course of business, court approval of the sale is required.¹⁷⁷ But if the trustee is authorized to run a business, sales within the ordinary course of business do not require court approval.¹⁷⁸

In any case, with regard to cash collateral, the trustee must always obtain either court approval¹⁷⁹ or the secured creditor's consent¹⁸⁰ to use

174. Cash collateral is defined broadly to include negotiable instruments, documents of title, deposit accounts, and other cash equivalents. 11 U.S.C. § 363(a) (Supp. 1991).

175. See U.C.C. § 9-306(2) (1972) (providing an automatic security interest in all proceeds of original collateral).

176. Cash collateral even includes amounts the secured creditor owes to the debtor that, but for the automatic stay in bankruptcy, the secured creditor could set off against counter-vailing obligations. *Ford Motor Credit Co. v. Jim Kelly Ford, Ltd.* (*In re Jim Kelly Ford, Ltd.*), 14 B.R. 812, 814 (N.D. Ill. 1980) (Shadur, J.). That is, the trustee may sometimes do more than withhold a portion of cash from the secured creditor. The secured creditor might have to pay that cash to the trustee, at which point it might be raided for § 506(c) expenses.

177. 11 U.S.C. § 363(b)(1) (1988).

178. *Id.* § 363(c)(1).

179. *Id.* § 363(c)(2)(B). A trustee can use cash collateral only if she is authorized to operate a business. *Id.* § 363(c)(1); *Cusanno v. Fidelity Bank*, 29 B.R. 810, 812-13 (E.D. Pa. 1983), *vacated*, 734 F.2d 3 (3d Cir. 1984).

180. 11 U.S.C. § 363(c)(2)(A). The consent pertaining to cash collateral must be "affirmative *express* consent from all parties involved before using cash collateral." *Freightliner Mkt. Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368 (9th Cir. 1987). "[I]mplied consent is insufficient." *Id.* at 368-69.

it.¹⁸¹ If courts sometimes hold that secured creditors have no right to adequate protection until they ask for it, when it comes to *cash* collateral, the trustee has an affirmative burden of showing the court that adequate protection has been provided.¹⁸²

But this may mean that the trustee can have cash collateral without adding anything at all to secured creditor rights, if other collateral is sufficient to cover the secured creditor's full claim. Equity cushions are routinely deemed adequate protection.¹⁸³ If, apart from the cash collateral, the secured creditor is still protected with an equity cushion, then the trustee may freely use the cash without undertaking any further adequate protection obligations.¹⁸⁴ For example, suppose the secured creditor claims \$90, but the collateral is \$90 in illiquid assets and \$10 in cash. If the trustee needs the \$10 in cash for purposes that cannot be brought within the meaning of section 506(c), and if the illiquid collateral is not

181. For remedies against the trustee for violating these rules, see John C. Chobot, *Enforcing the Cash Collateral Obligations of Debtors in Possession*, 96 COM. L.J. 136, 138 (1991). These remedies include retroactive adequate protection, denial of discharge, forfeiture of use of any further cash collateral, appointment of a trustee (in Chapter 11), and relief from the automatic stay.

182. *Travelers Ins. Co. v. Plaza Family Partnership (In re Plaza Family Partnership)*, 95 B.R. 166, 171 (E.D. Cal. 1989) (Coyle, J.) ("The primary concern of the court in determining whether cash collateral may be used is whether the secured creditors are adequately protected."); *In re Kain*, 86 B.R. 506, 512 (Bankr. W.D. Mich. 1988) (Gregg, J.). But see *Chrysler Credit Corp. v. Ruggiere (In re George Ruggiere Chrysler-Plymouth, Inc.)*, 727 F.2d 1017, 1019 (11th Cir. 1984) (Anderson, J.) ("Thus, when a creditor opposes a proposed use of cash collateral, the guiding inquiry is whether its security interests are 'adequately protected.'" (emphasis added)).

With regard to noncash collateral, it is frequently said that a secured creditor has no right to adequate protection until it asks for it. This claim, however, is controversial. Compare Julia A. Goatley, Note, *Adequate Protection and Administrative Expense: Toward a Uniform System for Awarding Superpriorities*, 88 MICH. L. REV. 2168 (1990) (arguing for such a requirement) with Carlson, *supra* note 75, at 146-50 (arguing against such a requirement).

183. *Pistole v. Mellor (In re Mellor)*, 734 F.2d 1396, 1400 (9th Cir. 1984) (Alarcon, J.).

184. *First Nat'l Bank v. Marine Optical, Inc. (In re Marine Optical, Inc.)*, 10 B.R. 893, 894 (D. Mass. 1981) (Bankr. App. Panel) (Cyr, J.) (holding that § 507(b) did not require court to save cash collateral lest equity cushion eroded); *In re Precast Structures, Inc.*, 122 B.R. 304, 305-06 (Bankr. S.D. Tex. 1990) (Clark, J.); *In re Landing Assocs.*, 122 B.R. 288, 291 n.3 (Bankr. W.D. Tex. 1990) (Clark, J.); *In re Triplett*, 87 B.R. 25, 26-27 (Bankr. W.D. Tex. 1988) (Ayers, J.); *In re Grant Broadcasting, Inc.*, 71 B.R. 376, 384-86 (Bankr. E.D. Pa.) (Scholl, J.), *aff'd*, 75 B.R. 819 (E.D. Pa. 1987); *In re Prime, Inc.*, 15 B.R. 216, 217-19 (Bankr. W.D. Mo. 1981) (Pelofsky, J.); Harvey R. Miller & Martin J. Bienenstock, *Adequate Protection in Respect of the Use, Sale or Lease of Property*, 1 BANKR. DEV. J. 47, 78-80 (1984); see also *Stein v. United States Farmers Home Admin.*, 19 B.R. 458 (Bankr. E.D. Pa. 1982) (Twardowski, J.). In *Stein*, the noncash collateral of an undersecured creditor was appreciating in value. *Id.* at 460. In light of this, Judge Twardowski allowed the debtor to have cash collateral because the secured creditor was obtaining appreciation value instead. *Id.* This decision is implicitly premised on the notion that appreciation value belongs to the debtor, and that the undersecured creditor is automatically capped by the initial valuation of the collateral. See Carlson, *supra* note 155, at 258-72.

expected to decline in value, the reorganization may have the \$10 cash without having to supply any adequate protection for it, because the cash is entirely debtor equity.

It is only when the use of cash collateral drives the secured claim under water that the trustee must do something positive about adequate protection.¹⁸⁵ In such a case, the trustee must supply substitute collateral¹⁸⁶ to make up for the cash taken.¹⁸⁷ Suppose, for example, the secured creditor claims \$90, but the collateral is \$80 in illiquid assets and \$10 in cash. If the trustee needs the \$10 in cash for purposes outside the scope of section 506(c), she will have to supply the secured creditor with \$10 of noncash collateral as a means of adequate protection. But adequate protection of cash collateral and the existence of 506(c) expenses are mutually exclusive ideas. If, on the one hand, the trustee wishes to use cash collateral for some purpose that benefits the general creditors, adequate protection of the secured creditor is required. On the other hand, if the trustee wishes to use the cash collateral to benefit the secured creditor within the meaning of section 506(c), no adequate protection is required, because the trustee is absolutely entitled to recover section

185. Some courts require the trustee to preserve the equity cushion for future accrual of postpetition interest and expenses. See *supra* text accompanying notes 31-39. The statement in the text does not hold if these cases represent the law. Instead, the trustee would have to preserve enough debtor equity to cover anticipated postpetition interest and collection expenses not yet accrued.

186. 11 U.S.C. § 361(2) (1988) (describing substitute collateral as a mode of adequate protection). Other modes of adequate protection would not be appropriate when the trustee wishes to invade cash collateral needed to keep a secured creditor fully secured. For example, § 361(1) authorizes cash payments, but there is no sense in paying cash when the point is that the trustee needs the cash collateral strictly because the estate is illiquid. See *In re Certified Corp.*, 51 B.R. 768, 771 (Bankr. D. Haw. 1985) (Chinen, J.) (trustee had to supply undersecured creditor with substitute collateral in order to take encumbered cash).

187. Many courts do not disclose whether the secured creditor is over- or undersecured. As a result, their rightness or wrongness pursuant to the text cannot be assessed. See, e.g., *In re International Horizons, Inc.*, 11 B.R. 366, 369 (Bankr. N.D. Ga. 1981) (ordering substitute collateral in exchange for permission to use cash collateral).

One student commentator proposes some rules for the use of cash collateral. See Stephen C. Mount, Note, *Standards and Sanctions for the Use of Cash Collateral Under the Bankruptcy Code*, 63 TEX. L. REV. 341, 352-61 (1984). The author argues that, early in the case or in emergency situations, a bankruptcy court could order the use of cash collateral without a hearing. Later, when no emergency exists, a hearing should be held, but cash may be used only for ordinary business expenses and only if a successful reorganization is in the offing. What is missing from this proposal is a discussion of whether the secured creditor is over- or undersecured. If the former is the case, the cash is simply debtor surplus—property of the estate—which could be spent for any purpose a trustee might legitimately have. If the latter is the case, the cash should be used for any legitimate purpose, but only if the cash is replaced with substitute collateral. In the latter case, if the expense falls under § 506(c) the trustee should get the cash without supplying adequate protection.

506(c) expenses from the collateral anyway.¹⁸⁸ Indeed, section 506(c) expenses cannot even be collected until noncash collateral is sold and thereby rendered into cash collateral. Therefore, in the above example, if the trustee can show that the expenses were reasonably necessary to preserve or dispose of collateral, the trustee may take the \$10 without replacing it with other substitute collateral.

As stated earlier,¹⁸⁹ one definition of value may require the deduction of transaction costs that the secured creditor would have borne under state law. That is, the secured claim is sometimes defined as what a buyer would pay, minus the transactions costs of sale. This deduction implies that the buyer pays in more than the secured creditor receives. Suppose the trustee does sell the collateral. In that case, part of the cash the buyer pays is always debtor equity, which is property of the estate. The rest belongs to the secured creditor as cash collateral.

If the trustee incurs section 506(c) expenses, the trustee should first use up the debtor equity,¹⁹⁰ including the equity created solely by reducing value by the amount of hypothetical transactions costs. If estimated transactions costs are accurate, the trustee never needs to reduce the size of the secured claim. But suppose section 506(c) expenses exceed the surplus. In such a case, the trustee must exhaust the surplus first and only then invade the secured claim.¹⁹¹

These are the rules when the cash surplus is still in place. But a smart trustee will make sure there is no surplus when it is time to invade the secured claim. If the cash is really surplus, the trustee (with court approval) can spend it without supplying adequate protection, provided she can prove that the noncash collateral will not depreciate in value. If the trustee takes this cash collateral and spends it, then, when it is time to charge 506(c) expenses, the trustee necessarily must invade the cash collateral needed to keep the secured creditor from becoming undersecured. The equity cushion previously in place is now gone, so that it can no longer be used to soak up the expenses sought under section 506(c). Such a scheme enriches the general estate at the expense of the secured creditor. Yet this scheme is authorized by the principle that says

188. To be sure, the trustee must first exhaust the debtor equity in the collateral, but once this is done, § 506(c), if it applies, negates any right the secured creditor has to adequate protection. See *supra* text accompanying notes 12-39.

189. See *supra* text accompanying notes 139-53.

190. See *supra* text accompanying notes 12-39.

191. *In re Codesco, Inc.*, 18 B.R. 225, 228-29 (Bankr. S.D.N.Y. 1982) (Schwartzberg, J.); cf. 11 U.S.C. § 364(d) (1988) (senior lien for new credit appropriate only if subordinated creditors are adequately protected and credit is not otherwise available). Of course, some courts would hold that the trustee can *never* invade the secured claim. See *supra* notes 159-61 and accompanying text.

that the trustee need not preserve debtor equity for unaccrued interest or collection expenses.

One line of authority rebels against this interpretation of the rules pertaining to cash collateral, according to which the trustee can take cash collateral freely, so long as the cash is part of debtor equity. In *Sun Bank/Suncoast v. Earth Lite, Inc. (In re Earth Lite, Inc.)*,¹⁹² Judge Paskay ruled that

the Debtor should not be permitted to use cash collateral without making some payments to the secured party just because it has, at the commencement of the case, a meaningful equity cushion in the collateral. To accept this proposition would mean that a debtor may freely use cash collateral until the collateral is reduced to the amount of indebtedness during which time the secured party is deprived of income, for which it bargained when the loan was granted.¹⁹³

On this view, excess cash collateral can only be taken if some paydown of the secured claim also occurs. Judge Paskay's proposed rule, however, does not seem to have been applied very often.¹⁹⁴ It has been expressly rejected at least once.¹⁹⁵

Other courts insist on putting severe restrictions on how cash collateral can be spent, even though the cash is part of the equity cushion. One month before his opinion in *Earth Lite*, Judge Paskay declined to impose the *Earth Lite* rule on the debtor. Rather, in *In re Mickler*,¹⁹⁶ Judge Paskay raised all the same concerns, and substantially restricted the amount of cash the Chapter 11 debtor could take for necessary living expenses.¹⁹⁷ And in *In re Dixie-Shamrock Oil & Gas, Inc.*,¹⁹⁸ Judge Paine required that the cash collateral, clearly part of the equity cushion, be spent solely on maintaining and repairing the collateral.¹⁹⁹ Such expenses probably would fall within the scope of 506(c) expenses. Restricting expenditure in this way is completely appropriate when no equity

192. 9 B.R. 440 (Bankr. M.D. Fla. 1981).

193. *Id.* at 444.

194. Judge Paskay's rule has been followed in *In re Epstein*, 26 B.R. 354, 357-58 (Bankr. E.D. Tenn. 1982) (Bare, J.); *cf. In re Polzin*, 49 B.R. 370, 374 (Bankr. D. Minn. 1985) (Mahoney, J.) (equity cushion was eroding too quickly to justify taking cash without further adequate protection).

195. *See In re Triplett*, 87 B.R. 25, 27 (Bankr. W.D. Tex. 1988).

196. 9 B.R. 121 (Bankr. M.D. Fla. 1981).

197. *Id.* at 124.

198. 39 B.R. 115 (Bankr. M.D. Tenn. 1984).

199. *Id.* at 118.

cushion exists,²⁰⁰ because such a restriction amounts to awarding the trustee 506(c) expenses. But such a restriction is questionable when the cash collateral falls entirely within the equity cushion not needed to adequately protect the secured claim.

This background will help elucidate the complicated cases that are discussed in the next section.

B. Charging the Secured Creditor With Ordinary Administrative Expense

1. The Existing Tests

Assuming that they are necessary and reasonable, and benefit the secured creditor, the expenses that can be charged with respect to a sale of collateral are not surprising: court costs, attorneys' fees, advertising, storage, and brokerage fees are among the items that courts routinely compensate.²⁰¹

In rehabilitative proceedings, however, property is not always sold. One difficult and confusing issue with regard to section 506(c) concerns the expense of maintaining collateral in a Chapter 11 case. Section 506(c) specifically mentions reimbursement for the expense of preserving the collateral. The expense of maintaining the collateral might alterna-

200. See *Hartigan v. Pine Lake Village Apartment Co. (In re Pine Lake Village Apartment Co.)*, 16 B.R. 750, 754-56 (Bankr. S.D.N.Y. 1982) (Schwartzberg, J.).

201. See generally WILLIAM COLLIER, COLLIER ON BANKRUPTCY ¶ 506.06 (15th ed. 1991) (discussing when costs and expenses of trustees are compensated). Among expenses not allowed under § 506(c) is the value of the trustee's own labor. See *Settles v. United States (In re Settles)*, 75 B.R. 229, 230 (Bankr. C.D. Ill. 1987) (Altenberger, J.) (holding that farmer debtor-in-possession not entitled to compensation for labor because § 506(c) is limited to reimbursement of the trustee's monetary expenditures); *Kotter v. First State Bank (In re Kotter)*, 59 B.R. 266, 269 (Bankr. C.D. Ill. 1986) (Altenberger, J.) (holding that wages for one debtor and use of debtors' land and machinery were not recoverable expenses under § 506(c)); *First Nat'l Bank v. B & L Enters., Inc. (In re B & L Enters., Inc.)*, 26 B.R. 220, 222-23 (Bankr. W.D. Kan. 1982) (Brown, J.) (holding that, in a Chapter 7 liquidation, trustee's statutory fee under § 326(a) cannot be brought in under § 506(c)); *Moister v. Farmers Bank (In re Truitt)*, 15 B.R. 169, 170 (Bankr. N.D. Ga. 1981) (Robinson, J.) (in selling the debtor's home, trustee may not recover commission under § 506(c)). But see *First Nat'l Bank v. Taylor (In re Modern Mix, Inc.)*, 18 B.R. 748, 749 (Bankr. S.D. Ala. 1982) (Caffey, J.) (trustee fee allocated to sale of collateral).

Nor can the trustee recover the expenses of resisting secured creditor efforts to lift the automatic stay. *In re Gire*, 107 B.R. 737, 738 (Bankr. E.D. Cal. 1989); see also *In re S & S Indus.*, 30 B.R. 395, 398 (Bankr. E.D. Mich. 1983) (Brody, J.) (no creditor committee expenses, unless the debtor consents); *Barr v. Juniata Valley Bank (In re DeLancey)*, 106 B.R. 363, 366 (Bankr. S.D.N.Y. 1989) (Schwartzberg, J.) (trustee could not collect expense of denying the debtor a discharge, where undersecured creditor would have benefited). It should be emphasized that in *DeLancey* the denial of discharge may have benefited the undersecured creditor's unsecured deficit claim, but it had nothing to do with administering the collateral itself, as § 506(c) requires. *Id.*

tively be (1) a safeguard that benefits the secured creditor and that the secured creditor ought to pay for; or (2) the very kind of expenses against which the secured creditor is entitled to adequate protection.²⁰² How can a court tell which is which?

The standard tests for determining which expenses are chargeable to the secured creditor and which are chargeable to the bankrupt estate are usually expressed in terms of a primary/indirect benefit distinction,²⁰³ or, alternatively, a purposeful/incidental²⁰⁴ or a definite/remote distinction.²⁰⁵ That is, the secured creditor can be made to bear an expense if the benefit received is primary, purposeful, or definite, but not if the benefit is indirect, incidental, or remote. These categories do not tell us anything. They depend entirely on presupposition and are therefore legal conclusions disguised as legal arguments.

Furthermore, in one sense expenses are *always* incidental if it is maintained that the trustee works for the general creditors, not the secured creditors.²⁰⁶ If the trustee's motive is the key to section 506(c)'s jurisdiction,²⁰⁷ then section 506(c) is written out of the Bankruptcy Code, because benefit to the secured creditor is always incidental. For instance, if a secured creditor holding a floating lien is undersecured, reorganization will be premised on generating enough value to pay off the secured claim with enough funds left over for the general creditors. In this sense, the secured creditor is only incidentally benefited, because the motive of

202. See *Pine Lake Village Apartment Co.*, 16 B.R. at 756.

203. *New Orleans Pub. Serv., Inc. v. First Fed. Sav. & Loan Ass'n (In re Delta Towers, Ltd.)*, 924 F.2d 74, 77 (5th Cir. 1991); *Central Bank v. Cascade Hydraulics & Util. Serv., Inc. (In re Cascade Hydraulics & Util. Serv., Inc.)*, 815 F.2d 546, 548 (9th Cir. 1987) (Wright, J.); *Brookfield Prod. Credit Ass'n v. Borron*, 738 F.2d 951, 953 (8th Cir. 1984) (McMillian, J.); *DeLancey*, 106 B.R. at 366 (primary versus indirect); *In re West Post Rd. Properties Corp.*, 44 B.R. 244, 246 (Bankr. S.D.N.Y. 1984) (Schwartzberg, J.) (trustee expenses fall under § 506(c) "when expenses of preservation are incurred primarily for the benefit of the secured interest"); *In re Codesco, Inc.*, 18 B.R. 225, 228-29 (Bankr. S.D.N.Y. 1982) (Schwartzberg, J.).

204. *General Elec. Credit Corp. v. Peltz (In re Flagstaff Foodservice Corp.)*, 762 F.2d 10, 12 (2d Cir. 1985) (Van Graafeiland, J.).

205. *Communication & Studies Int'l, Ltd. v. Bank of Am., N.T. & S.A. (In re World of English, N.V.)*, 21 B.R. 524, 527 (Bankr. N.D. Ga. 1982) (Drake, J.) (finding connection between expense and benefit to be sufficiently direct); *Codesco*, 18 B.R. at 229 ("too indefinite and remote to support an allowance").

206. See, e.g., *In re Trim-X, Inc.*, 695 F.2d 296, 301 (7th Cir. 1982) (Swygert, J.).

207. See *Sells v. Sonoma V (In re Sonoma V)*, 24 B.R. 600 (Bankr. 9th Cir. 1982) (trustee who proved mechanic's lien did not exist could not recover expenses from the mortgagee second in line because the trustee eliminated the lien for the benefit of the general creditors); *Brookfield Prod. Credit Ass'n v. Borron*, 36 B.R. 445, 448 (E.D. Mo. 1983) ("To recover, the debtor-in-possession must expend the funds primarily to benefit the creditor, who must in fact directly benefit from the expenditure. Expenses undertaken to improve the position of the debtor-in-possession, although indirectly benefiting the creditor, are not recoverable."), *aff'd*, 738 F.2d 951 (8th Cir. 1984).

the trustee is to obtain value for the unsecured creditors.²⁰⁸ Only if you accept the premise that reorganizations *can* benefit secured parties is it possible to use a primary/indirect distinction.²⁰⁹

Another popular test²¹⁰ for determining when maintenance costs fall within the scope of section 506(c) is derived from a pre-Code case, *First Western Savings & Loan Ass'n v. Anderson*,²¹¹ in which Judge Hamley of the Ninth Circuit remarked, "[i]n every case where free assets are insufficient, the court should balance the misfortune of having some allowances go unpaid against the possible inequity of charging them all against mortgaged property."²¹² To this was appended a long footnote enumerating factors justifying 506(c) charges, which may be paraphrased as follows: (1) If things had gone well, would the secured creditors have "benefited"? (2) Were services rendered primarily for the secured creditors? (3) Were the services competently delivered? (4) Did the secured creditors consent? (5) Did the secured creditors cause any delays?²¹³

These standards are not as impressive as they might seem at first glance. The first standard simply repeats the statute and is of no help. The second repeats the primary/indirect test, also a test without content. The third standard, in requiring competence, probably repeats the statutory requirement that the expenses were necessary. The fourth standard repeats the "consent" test.²¹⁴ And the final test seems contrary to the Bankruptcy Code, since secured creditors have no duty to cooperate with

208. See *In re Roamer Linen Supply, Inc.*, 30 B.R. 932, 936-37 (Bankr. S.D.N.Y. 1983) (Schwartzberg, J.) ("It defies credulity to have this court believe that the debtors and their attorneys labored to negotiate a liquidation on a going concern basis . . . so as to enhance primarily the collateral . . .").

209. See *In re Gagel & Gagel*, 24 B.R. 674, 675 (Bankr. S.D. Ohio 1982) (Anderson, J.) ("a reorganization plan may consist of only a workout with secured creditors"). See also Rubin, *supra* note 26, at 424:

The competence of the trustee and his counsel redounds to the possible benefit of all classes of creditors. The failure of reorganization may mean that the efforts on behalf of these classes have failed. But no reason appears why only unsecured creditors—who may not have instituted the proceedings, who may have demanded immediate liquidation, who may all along have protested the proceedings—should be made to pay the costs.

210. *In re Bob Grissett Golf Shoppes, Inc.*, 50 B.R. 598, 603 (Bankr. E.D. Va. 1985) (Bossetter, J.), *modified*, 76 B.R. 89 (Bankr. E.D. Va. 1987); *In re Manchester Hides, Inc.*, 32 B.R. 629, 634 (Bankr. N.D. Iowa 1983) (Thinnes, J.); *In re Korupp Assocs.*, 30 B.R. 659, 662 (Bankr. D. Me. 1983) (Goodman, J.); *Communication & Studies Int'l, Ltd. v. Bank of Am., N.T. & S.A. (In re World of English, N.V.)*, 21 B.R. 524, 527 (Bankr. N.D. Ga. 1982) (Drake, J.).

211. 252 F.2d 544 (9th Cir. 1958).

212. *Id.* at 548.

213. *Id.* at n.8.

214. This test is discussed in the context of liquidations *supra* in the text accompanying notes 163-73.

the bankruptcy trustee. Why should the secured creditors pay for trustee expenses incurred simply because the secured creditors pursued their rights under the Bankruptcy Code?²¹⁵ For these reasons, the *Anderson* test does not seem sufficient. Can a better mediating principle be found than these conclusory distinctions?²¹⁶

2. A Proposed Mediating Principle

Here is a suggested compromise. It requires a two-step analysis. The first step requires the court to determine whether debtor equity exists. If it does, then, pursuant to the priorities established in the first part of this Article,²¹⁷ the trustee must take any expenses out of the debtor equity. In the second step, the court must determine who owns the cash flow of the debtor-in-possession. If all income is subject to a floating lien, then maintenance of the income should be charged to the secured creditor. If the income is unencumbered, then at best—depending on which

215. In the much cited case, *In re Trim-X, Inc.*, 695 F.2d 296 (7th Cir. 1982), the trustee retained collateral for appraisal. When the appraisal suggested that the collateral was over-encumbered, the trustee moved to abandon it. The trustee then asked for compensation for keeping the collateral from the time he was appointed until the time the collateral was abandoned. Citing *Anderson*, Judge Swygert ruled:

Although the secured creditor eventually "benefited" from these expenses in the sense that it received the assets unharmed, it did not in any way consent to or cause these expenses. Further, placing the responsibility for these expenses on a secured creditor would discourage a trustee from taking reasonable steps to assess an estate's position.

Id. at 301. Based on these principles, Judge Swygert decided that, after the trustee proposed abandonment, the secured creditor delayed its objection to bearing the expense too long. In Swygert's opinion, this delay justified charging the expense to the secured creditor. *Id.* The benefit started when the trustee proposed to abandon the property and ended when the secured creditor answered the petition by objecting to the imposition of § 506(c) charges. *Id.*

Even if "causation" were a standard authorized by § 506(c), it is hard to swallow the fact that the secured creditor "caused" the § 506(c) expense by delaying its objection to them. Those expenses would have continued in any case until such time as the trustee obtained court approval for abandonment under Bankruptcy Code § 554. See also *In re West Post Rd. Properties Corp.*, 44 B.R. 244, 246 (Bankr. S.D.N.Y. 1984) (Schwartzburg, J.) (section 506(c) charges are appropriate when the secured creditor causes such expenses).

216. In *In re Chicago Lutheran Hospital Ass'n*, 89 B.R. 719 (Bankr. N.D. Ill. 1988), it was argued that because the Supreme Court imposed costs on undersecured parties in *United Savings Ass'n v. Timbers of Inwood Forest Associates.*, 484 U.S. 365 (1988), § 506(c) should be interpreted to do the same. *Chicago Lutheran Hosp.*, 89 B.R. at 731-32. Judge Robert Ginsburg was unimpressed:

It is true that the United States Supreme Court has ruled that it is constantly permissible for an unsecured creditor to be required to bear some of the cost of a reorganization effort. However, it requires a quantum leap to conclude that Congress did in fact intend to impose the costs of a failed reorganization effort on secured creditors in [§ 506(c)].

Id. (citations omitted).

217. See *supra* text accompanying notes 12-39.

valuation theory the court uses—only a small portion of the going concern expenses should be charged, according to what the secured creditor would have borne had there been no bankruptcy.

a. Encumbered Income

We start with security interests that encumber the entire income stream of a firm. In such a case, the secured creditor should be charged with the maintenance of that income stream under section 506(c). This proposition can best be understood in the context of valuation theory. The value of the collateral is a function of future income reduced to present value. Hence, any valuation of the secured creditor's interest must include prospective income. But as time goes by, the income, as it accrues, is not necessarily the collateral itself, even though it is the benchmark by which the value of the collateral is calculated.²¹⁸ Rather, the income may belong to the debtor, while the capital asset belongs to the creditor. The division of property into income and capital (or, as the common-law lawyers would have called it, the equitable and legal title) is mitigated by the fact that the debtor is obligated to pay debt service. If the debtor does not do so, then the secured creditor can repossess the collateral and, with it, the right to collect future income. The collection of future income is accomplished when the collateral is sold at a foreclosure sale, because the buyer is paying a price that capitalizes future income into present value.

The sale of the collateral, then, is tantamount to the secured creditor recapturing the cash flow from the capital asset. Obviously, the secured creditor cannot always trust the debtor to maintain the collateral so that the present value of the collateral is preserved at a constant level. Instead, the secured creditor may suspect that the debtor may try to depreciate the collateral early, taking out excess income and leaving the secured creditor with a low-value asset upon default. In other words, the debtor has power to change from a long-term strategy to a short-term

218. Judge Leif Clark recognized this in *In re Landing Assoc.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990):

The appraisals only valued the interest conferred by the [secured party's] deed of trust. They did not purport to value the wholly separate interest conferred by [the secured creditor's] entitlement to rents *prior* to foreclosing on the property. To be sure, the appraisals examine the rental stream, but only in the context of its representing the income *capacity* of the property *after* its sale (by foreclosure or otherwise).

Id. at 297. The "or otherwise" should be taken to mean "any sale free and clear of the mortgage lien."

Judge Clark fell into serious error, however, when he insisted on valuing the collateral and the income stream separately. In fact, the collateral is *nothing but* prospective income.

strategy in exploiting the capital. To guard against this danger, creditors commonly insist that some of the cash surplus be used to pay down the principal amount in the hope that the outstanding capital debt remains fully collateralized. Installments on principal therefore help guarantee that the capital liability depreciates as fast or faster than the capital asset.

As an additional refinement, secured creditors can often encumber the income stream itself. Typically, the secured creditor authorizes the debtor to control the income stream until default. After default, the secured creditor has the option to collect cash proceeds. Thus, with real estate mortgages, for example, the law often awards rental income to the mortgagee between the time collateral is repossessed and the time it is sold.

That a security interest encumbers the income stream itself ends up being somewhat overrated, in terms of the theory of secured lending. The typical pattern is for the secured creditor to authorize the debtor to use the encumbered income for maintenance expenses, debt service, and perhaps some paydown of the collateral. In such an arrangement, the debtor is entirely free to spend the extra money at her discretion until default occurs. This is more or less the situation when the income stream is not deemed collateral but is instead simply viewed as an attribute of owning capital.

Suppose it were otherwise. Suppose a mortgage agreement requires that all rental income be applied to pay down the mortgage debt. The debtor is allowed no living expenses and no income to pay taxes, hire groundskeepers, maintain the common areas, or perform similar tasks. Instead, the mortgage agreement requires the debtor to meet these expenses from her own private funds, while the rental income goes entirely to pay the principal amount of the loan. In such a case, the mortgagee has, in effect, arranged for a very rapid paydown of principal, one that occurs faster than the income from the collateral would otherwise justify. Such an unusual requirement obviously requires the debtor to contribute funds from sources other than the income from the capital. For an economically rational debtor to do so, it must still be expected that the capital will be self-supporting. What the debtor contributes today toward maintenance of the capital base (because income is not available for this purpose) she must recover later after the mortgage debt is paid off. Otherwise, the debtor has no motive to agree to such a surrender of all rights to income.

What the above discussion has attempted to establish is that, in economically rational secured lending, a loan is premised on self-supporting collateral, with income sufficient to cover maintenance expenses and debt service. Furthermore, if the income stream should change over time for

the worse, economic rationality demands that the debt be paid down to a point at which the property is still self-sustaining. Of course, if the debtor cannot afford to pay down the debt, the secured creditor can foreclose and sell the property to a buyer who will finance the purchase by borrowing at a level in which the property once again becomes self-supporting.

If bankruptcy is viewed as a general cure of defaults and a de-acceleration of debts and contracts,²¹⁹ then bankruptcy should, as a theoretical matter, have the effect of disencumbering the income stream. In exchange for this, the present value of the capital base is preserved through maintenance and management, and the secured creditor obtains debt service—perhaps reduced if the income stream has shrunk since the original mortgage agreement was executed.

The Bankruptcy Code reflects this vision. A secured creditor who dissents from a Chapter 11 plan, in a cram down, can be forced to take rights roughly described above, provided that:

(I) the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of such claims; and

(II) that each holder . . . receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in . . . such property.²²⁰

That is, under the cram down idea, the secured creditor's collateral is valued as the net future income of the collateral reduced to present value. If the secured creditor is to receive payments over time, these payments must have a present value equal to the collateral. The discount rate on these future payments should precisely equal the net expected future income of the collateral. If the property is depreciating, the net-income idea implies that part of the income is charged against depreciation expense. This expense is paid to the lender as a means of paying principal,²²¹ so that the cram down plan represents an installment loan in which principal is slowly retired. This is especially so when the statutory cram-down requirements are supplemented by the judge-made rule that outstanding principle must not dip below the value of the collateral.²²²

219. This is a major theme of Bankruptcy Code § 365(b) (cure and reinstatement of executory contracts) and § 1123(b) (cure and reinstatement of loan agreements).

220. 11 U.S.C. § 1129(b)(2)(A)(i) (1988).

221. Cf. *id.* § 361(1) (cash payments for depreciation expense).

222. See *Abbott Bank-Thedford v. Hanna (In re Hanna)*, 912 F.2d 945, 949-51 (8th Cir. 1990) (Chapter 12); *In re O'Farrell*, 74 B.R. 421, 424 (Bankr. N.D. Fla. 1987) (if long-term

It is significant that the secured creditor in a cram down receives the present value of only *net* future income. That is, future income is disencumbered so that the surviving firm can use the income to maintain the property. This cram-down phenomenon implies that, in the period before confirmation of the reorganization plan, cash collateral should likewise be disencumbered to maintain the integrity of the cash flow.

For this reason, if a secured creditor has encumbered income and claims it as cash collateral, any expense that is incurred to maintain that income should be chargeable to the secured creditor under section 506(c). Furthermore, since the economics of lending presuppose that the debtor will be paid for managing the property—economists would call this expectation the debtor's opportunity costs—even some compensation to the trustee should fall under section 506(c), at least as a matter of theory.²²³

If the cram down provision awards to the secured creditor debt service based on the value of the collateral, and if, on the basis of this, income should be disencumbered on behalf of the trustee, then economic theory demands that the secured creditor should obtain pre-cram-down debt service in exchange for pre-cram-down disencumbrance.

The Bankruptcy Code conforms to this demand. Undersecured creditors have been deprived of their postpetition interest by *United Savings Ass'n v. Timbers of Inwood Forest Associates*.²²⁴ But this rule does not apply to undersecured creditors who have encumbered the income stream.²²⁵ As the income accrues, the collateral grows in size, while the

debt instruments are given to a secured creditor, the secured creditor must also have adequate protection over the life of the debt); *In re Butler*, 97 B.R. 508, 513 (Bankr. E.D. Ark. 1988) (same result in a chapter 12 case); *In re Johnson*, 63 B.R. 550, 554 (Bankr. D. Colo. 1986).

223. *But see Settles v. United States* (*In re Settles*), 75 B.R. 229, 230 (Bankr. C.D. Ill. 1987) (Altenberger, J.) (farmer debtor-in-possession not entitled to compensation for labor because § 506(c) is limited to reimbursement of the trustee's monetary expenditures); *Kotter v. First State Bank* (*In re Kotter*), 59 B.R. 266, 269 (Bankr. C.D. Ill. 1986) (Altenberger, J.) (same). Cases in which the secured creditor does not own the income stream or straight liquidation cases rest on a different footing. In these cases, it is appropriate that compensation for the trustee is forbidden to come within the scope of § 506(c). *See, e.g., First Nat'l Bank v. B & L Enters., Inc.* (*In re B & L Enters., Inc.*), 26 B.R. 220, 222-23 (Bankr. W.D. Kan. 1982) (Brown, J.) (in a Chapter 7 liquidation, trustee's statutory fee under § 326(a) cannot be brought in under § 506(c)); *Moister v. Farmers Bank* (*In re Truitt*), 15 B.R. 169, 170 (Bankr. N.D. Ga. 1981) (Robinson, J.) (in selling the debtor's home, trustee may not recover commission under § 506(c)).

224. 484 U.S. 365 (1988). For a further discussion of *Timbers*, see *supra* notes 68-79 and accompanying text.

225. Income producing property has always been an exception to the rule that undersecured creditors may not obtain postpetition interest. *Ex Parte Penfold*, 87 Rev. Rep. 385, 386 (1851); Carlson, *supra* note 1, at 590-95.

capital asset (a reflection of prospective income only) stays the same.²²⁶ Out of this increase, the secured creditor obtains something resembling the postpetition interest, while the estate gets the balance of income. Under the reading of section 506(c) proposed here, the secured creditor is responsible for the maintenance expense of the income stream. Only the balance left over comprises the quasi-interest payments described above.²²⁷

This theory refers to the expenses necessary to generate income, but it does not address the actual costs of formulating and confirming a Chapter 11 plan.²²⁸ In cases involving floating liens, in which all income is encumbered, resolving whether these expenses can come in under section 506(c) will determine whether a reorganization proceeding is even possible. Given that a Chapter 11 plan substitutes for a foreclosure sale—the expense of which a secured creditor would bear—a good argument exists for imposing this expense on the secured creditor. This is especially so if the proceeding succeeds in producing a large going concern bonus for the secured creditor, as happened in *In re Pullman Construction Industries*.²²⁹ In *Pullman*, the secured creditor, a floating lienor, claimed \$8 million in prepetition amounts.²³⁰ Judge Schmetterer estimated the corporation's liquidation value at \$2,579,750²³¹ and going-concern value to be \$5 million.²³² Such a large going-concern surplus represents value added to what the secured creditor would have obtained on its own. It should have been easy for Judge Schmetterer to bring the cost of reorganization within section 506(c) on these numbers, but he declined to do so.²³³

A good rule for cases involving encumbered income and under-secured creditors would invoke section 506(c)'s central concept and charge these creditors with the costs of reorganization, but only to the extent they "benefit" the secured creditor. This should mean that, in

226. Either the collateral does not depreciate, or, if it does, the secured creditor is compensated for depreciation by adequate protection payments under Bankruptcy Code § 361(1).

227. See *In re Landing Assocs.*, 122 B.R. 288, 297 (Bankr. W.D. Tex. 1990) (Clark, J.) (where secured creditor did not object, secured creditor's interest in rental income limited to net rent after income).

228. See *In re Pullman Constr. Indus.*, 107 B.R. 909, 934 (Bankr. N.D. Ill. 1989) (Schmetterer, J.) ("The only corporate liabilities considered when utilizing a discounted cash flow approach are current, operating expenses, such as labor, materials, overhead, salaries, and other items that must be paid to generate the cash inflows.").

229. 107 B.R. 909 (Bankr. N.D. Ill. 1989) (Schmetterer, J.).

230. *Id.* at 915.

231. *Id.* at 936. At the start of the case, the court had estimated the company's liquidation value at \$3,182,500. *Id.* at 919.

232. *Id.* at 933.

233. *Id.* at 940-43.

cases in which the reorganization produces a going-concern bonus for the secured creditor, reorganization costs might be imposed only up to the amount of the bonus. These costs should not be imposed if they mean that, in Chapter 11, the secured creditor would do worse than it would do under state-law foreclosure.

In *Pullman* the debtor-in-possession aggressively claimed that not only the costs of counsel in the Chapter 11 proceeding should be covered, but many other prepetition and postpetition claims as well.²³⁴ The list consisted of all claims—including some prepetition claims—that section 1129(a) required to be paid before a Chapter 11 plan could be confirmed.²³⁵ In other words, the debtor-in-possession asked that payment to unsecured priority creditors be made into a 506(c) expense,²³⁶ because paying those creditors was necessary to confirm a Chapter 11 plan and therefore capture the going-concern bonus for the secured creditor. Unless this was done, or unless new value were contributed to the firm, the plan could not be confirmed.²³⁷

Judge Schmetterer felt this request was too much to bear. "Such theory," he wrote, "is not supported by law, logic, or authoritative economic evidence."²³⁸ But, in fact, these expenses were simply the *sine qua*

234. *Id.* at 934.

235. See 11 U.S.C. § 1129(a) (1988). For example, the debtor-in-possession sought to bring the following prepetition unsecured claims within the purview of § 506(c). First, a prepetition tax claim, with a priority under § 507(a)(7), which must be paid in full within six years. *Id.* § 1129(a)(9)(C); *Pullman*, 107 B.R. at 915 n.4. Second, a priority wage-benefit claim, which must be paid in cash, if the claimant votes against the plan. See 11 U.S.C. §§ 507(a)(4), 1129(a)(9)(B). The claimants voted to accept the *Pullman* plan, however, and were to be paid over one year. *Pullman*, 107 B.R. at 915. Third, a senior mechanics' lien claim, which encumbered an account receivable. *Id.* Such claims must be paid or otherwise crammed down at full value. See 11 U.S.C. § 1129(b)(2)(A).

236. The debtor-in-possession made this request in two different ways. First, it requested that the valuation of the going concern be reduced by the cost of administration. *Pullman*, 107 B.R. at 940. Second, it requested that the valuation not be so reduced, but that the secured claim be reduced pursuant to § 506(c). See *id.* at 941. Since, either way, a radically undersecured creditor bears these costs, there is no need to distinguish between each of these claims and both may be treated as 506(c) claims. Judge Schmetterer, however, thought that the valuation claim rendered § 506(c) into "mere surplusage." *Id.* at 940.

237. In fact, the costs of reorganization were so large that the going-concern bonus was overwhelmed. *Id.* at 934. This left the old shareholders with a dilemma: under the absolute priority rule, the secured creditor could use its unsecured deficit to guarantee that no old shareholder receive any value under the plan. 11 U.S.C. § 1129(b)(2)(B)(ii). The old shareholders proposed to exploit the controversial "new value" exception to the absolute priority rule to justify their continuation as shareholders. *Pullman*, 107 B.R. at 943-48. Because of valuation problems, however, Judge Schmetterer ruled that these shareholders could not avail themselves of this exception. *Id.* at 949-51.

238. *Pullman*, 107 B.R. at 940. In explaining this conclusion, Judge Schmetterer makes several errors. First, Schmetterer remarks, "That argument could be made in virtually every bankruptcy case, because successful reorganization is the predicate of realizing going concern

non of the going-concern bonus, all of which was going to the secured creditor. For this reason, the expenses should have been allowed under section 506(c), at least to the extent of the going-concern bonus.

b. Unencumbered Income

If the income stream is unencumbered by a floating lien, then, in an economically rational deal, section 506(c) will never come into play. The encumbered capital base should produce enough income to maintain itself. Furthermore, under *Timbers* the undersecured creditor has no right to debt service at all from this unencumbered income. Therefore, the trustee has an opportunity to gain at the secured creditor's expense (or to keep a nonviable property afloat longer), because she can avoid using the income for debt service.²³⁹

Nevertheless, even with this subsidy, the secured creditor might need to go beyond income and invade principal as well. Some might justify a strict reading of section 506(c) because, if the trustee cannot make a go of it even though the secured creditor was made to subsidize the trustee by foregoing debt service, then the trustee's need for section 506(c) suggests truly poor judgment by the trustee in keeping the enterprise going. This poor judgment should be punished by a denial of compensation under section 506(c).

Of course, section 506(c) does authorize the trustee to charge to the secured creditor "the reasonable, necessary costs and expenses of *preserving . . .* such property."²⁴⁰ A rule against charging going-concern ex-

value." *Id.* In fact, this argument applies only in cases in which an undersecured floating lienor has encumbered the income stream of the firm. Not all reorganizations suffer from this feature. Second, Judge Schmetterer thought that the debtor's valuation expert, Robert S. Hamada of the University of Chicago, had contradicted his testimony in *In re Jartran, Inc.*, 44 B.R. 331, 352 (Bankr. N.D. Ill. 1984) (Fisher, J.). *Pullman*, 107 B.R. at 941. There, Hamada calculated going-concern value without subtracting the costs of reorganization. But it is apparent in that case that sufficient unencumbered assets existed to pay substantial dividends to nonpriority creditors. See *Jartran*, 44 B.R. at 345. Therefore, in *Jartran* the costs of reorganization could be taken from debtor equity and did not adversely affect the size of the secured claims. Third, Schmetterer saw the debtor's request as transforming unsecured claims into superpriority claims for postpetition credit under Bankruptcy Code § 364(d), when no such credit had been extended. *Pullman*, 107 B.R. at 940. In fact, they become § 506(c) expenses, which clearly outrank secured claims. *In re Saybrook Mfg. Co.*, 130 B.R. 1013, 1021 (Bankr. M.D. Ga. 1991) (Hersher, C.J.) (noting that § 506(c) permits invasion of liens granted under § 364(d)).

239. Justice Scalia apparently realized this to be a weakness of his opinion in *Timbers*. His attempt to counter this incentive was to urge bankruptcy courts to allow the stay to be lifted under § 362(d)(2)(B) whenever it appeared that the reorganization was unlikely to result in a confirmable Chapter 11 plan. *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 375-76 (1988).

240. 11 U.S.C. § 506(c) (emphasis added).

penses under section 506(c) would read the above-quoted words out of the Bankruptcy Code, a result that *Timbers* itself does not allow.²⁴¹

Here is a compromise that gives meaning to the above-quoted words of section 506(c). This compromise is based upon the familiar hypothetical imagining exercise that requires us to ask what expense the secured creditor would have incurred if the debt were in default and the secured creditor were liquidating collateral in a reasonable manner.²⁴² If the court has used a liquidation valuation standard, these costs have already been taken out of the valuation. Charging the secured creditor again would appear to be double-dipping by the trustee. A liquidation standard therefore should be deemed to rule out any preservation expenses in a Chapter 11 case.

A different rule would apply if a court has used a going-concern valuation standard. Under this standard, there *are* no hypothetical costs of selling the collateral. As a result, the secured creditor's secured claim will be deemed larger than if a liquidation standard were used. Under this valuation theory, the court should deduct the preservation expenses the secured creditor would have incurred if the secured creditor had foreclosed in the absence of bankruptcy.²⁴³

c. Summary

The previous discussion has suggested a rule for charging administrative expenses of a going concern to secured creditors: when no debtor equity exists and when the security agreement covers the entire income stream of the enterprise, the secured creditor should bear the expense of maintaining the income stream and should take only the net income, plus any additional payments needed to cover depreciation of the capital base. If the debtor owns the income stream, the debtor should use that income stream to protect adequately the collateral and otherwise run the enter-

241. According to Justice Scalia, any interpretation of the Bankruptcy Code that renders statutory words useless is defective. See *supra* text accompanying notes 68-79.

242. *Brookfield Prod. Credit Ass'n v. Borron*, 738 F.2d 951, 953-54 (8th Cir. 1984) (Bright, J., dissenting) (between August and Thanksgiving the secured creditor would have fed the turkeys anyway, and so should be charged with this expense under § 506(c)). In *Borron*, the majority thought that feeding turkeys only "indirectly" preserved the value of the collateral for the secured creditor. *Id.* at 952-53. Obviously, the court does not know much about animal husbandry or, for that matter, Thanksgiving. See also *Erie Hilton Joint Venture v. Prudential Ins. Co. of Am.*, 125 B.R. 140, 148-50 (Bankr. W.D. Pa. 1991) (Bentz, J.) (secured creditor had to bear real estate taxes between lifting the automatic stay and sheriff's sale).

243. *In re World Wines, Ltd.*, 77 B.R. 653, 658 (Bankr. N.D. Ill. 1987) (Coar, J.) (where stay was lifted and secured creditor repossessed, pre-repossession storage expense could be brought under § 506(c)). But see *In re Trim-X, Inc.*, 695 F.2d 296, 301 (7th Cir. 1982) (Swygert, J.) (pre-abandonment expenses did not benefit secured parties and therefore could not be charged under § 506(c)).

prise. No section 506(c) expenses should be allowed in this case, except those corresponding to the costs a secured creditor would have borne if there had been no bankruptcy and the secured creditor took control of the business for the purpose of foreclosing on it instead. Even here, this deduction should occur only if the bankruptcy court has valued the collateral according to a "going-concern" theory, whereby no hypothetical transaction costs have reduced the secured claim.

The next section critically analyzes the existing case law from the perspective of this proposal for deciding when to charge administrative expenses to secured creditors.

C. *The Existing Law of Encumbered Income Streams*

The following cases involve floating liens of secured creditors that soak up most or all of the property of the debtor. In these cases either the debtor has no equity in the collateral or what equity there was has been dissipated. As a result, the trustee is in the position of having to bring her expenses within the scope of section 506(c), so that she can force the secured creditors to pay the bill.

1. Cases That Hold the Secured Creditor Harmless From Administrative Expenses

Proving that the quality of mercy is strained after all, some courts refuse to make the secured creditor bear the expense of general administration under any conditions. The U.S. Court of Appeals for the Second Circuit has taken the lead in cases of this genre, in two separate opinions involving the Flagstaff Foodservice bankruptcy.

Like most failing businesses, Flagstaff had encumbered every last scrap of property before seeking refuge in Chapter 11. Its principal financier, General Electric Credit Corporation (GECC), was in for \$22 million at the time of the bankruptcy petition, but it was secured by \$42 million in assets.²⁴⁴ It is not clear where this valuation of assets came from. The officers of Flagstaff claimed on appeal that this number represented the going concern value of the firm.²⁴⁵ The book value seemed lower.²⁴⁶ The hypothetical liquidation value would have been lower still.

244. *General Elec. Credit Corp. v. Peltz* (*In re Flagstaff Foodservice Corp.*), 762 F.2d 10, 11 (2d Cir. 1985) (Van Graafeiland, J.).

245. *Id.* at 12.

246. The bankruptcy court noted that the scheduled assets were only \$32 million, although a contingent claim against another entity was not listed on the schedule. *Allstate Fabricators Corp. v. Flagstaff Foodservice Corp.* (*In re Flagstaff Foodservice Corp.*), 56 B.R. 899, 906 (Bankr. S.D.N.Y. 1986) (Abram, J.).

In any case, to keep the firm going, GECC agreed to supply an extra \$9 million in exchange for a superpriority lien on all the firm's assets.²⁴⁷ It quickly became apparent that the business was not viable. At first, Flagstaff hoped to remain in Chapter 11 by means of a liquidating Chapter 11 plan, but even this was not possible. Thus, like ninety percent of Chapter 11 filings,²⁴⁸ the Flagstaff case devolved into a Chapter 7 liquidation.²⁴⁹

By the time it became clear that the reorganization could not succeed, Flagstaff had paid down most of GECC's claim. Flagstaff still owed about \$4 million, but, by this time, GECC was undersecured.²⁵⁰ At this stage, all remaining assets of the debtor were encumbered by GECC's lien—perhaps by the prebankruptcy security interest or by the postpetition superpriority lien, depending on what assumptions were made about the retirement of GECC claims.

This is a common enough dilemma in Chapter 11. Chapter 7 conversions often happen precisely when no unencumbered assets are left. In the *Flagstaff* decisions, two influential groups had discovered they had not yet been paid—the lawyers and the Internal Revenue Service (IRS).²⁵¹ The IRS claims were for withholding taxes. If the IRS does not receive these “trust fund taxes,” the officers are made personally liable.²⁵² Hence the officers took up the cause of paying the IRS with enthusiasm.

The IRS and the lawyers could only obtain payment if they could get cash collateral under section 506(c). Accordingly, they sought a ruling from the court that the attorneys' fees and the withholding taxes ought to be paid out of GECC's collateral.²⁵³

Judge Prudence Abram granted both the attorneys' fees and the withholding tax claim out of GECC's collateral. Ruling on the withholding tax claim, she emphasized the fact that the entire Chapter 11

247. This is permitted by Bankruptcy Code § 364(d). See 11 U.S.C. § 364(d) (1988).

248. See *In re Robbins*, 119 B.R. 1, 5 (Bankr. D. Mass. 1990) (Queenan, J.).

249. *Allstate Fabricators*, 56 B.R. at 900.

250. *General Elec. Credit Corp. v. Peltz (In re Flagstaff Foodservice Corp.)*, 762 F.2d 10, 11 (2d Cir. 1985) (Van Graafeiland, J.).

251. *Allstate Fabricators*, 56 B.R. at 901.

252. 26 U.S.C. § 6672(a) (1988).

253. To be perfectly accurate, some of the lawyers did not cite § 506(c) as authority for their getting paid. Instead, they must have relied on the general administrative priority that lawyers for creditor committees often get. *Wilson Freight Co. v. Citibank, N.A.*, 21 B.R. 398, 401 (S.D.N.Y. 1982) (Knapp, J.). Some of these services included trying to avoid GECC's lien. Nevertheless, the district court approved GECC's paying for these so-called services on the theory that “the ‘context’ of the case ‘necessarily imports’ that appellees’ services benefited GECC ‘by preserving or enhancing the bankrupt estate.’” *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 76 (2d Cir. 1984).

filing was for the benefit of GECC, in that it had generated a payout of about \$27 million to GECC. She wrote:

GECC has indeed been the primary financial beneficiary of the Chapter 11 liquidation effort since it holds a security interest on all assets in the estates [of the various corporate entities comprising Flagstaff] and those assets have not yet yielded enough to pay off the indebtedness due it.²⁵⁴

Furthermore, Judge Abram thought that, by cooperating with the Chapter 11, GECC had consented to the administrative expenses and therefore could not now challenge their allowance under section 506(c).²⁵⁵

GECC appealed both defeats. The U.S. Court of Appeals for the Second Circuit agreed with GECC. With regard to attorneys' fees, Judge Van Graafeiland zeroed in on the fact that at the start of the Chapter 11 case, GECC was substantially oversecured. "As a matter of fact," Van Graafeiland remarked, "it requires rather strained logic to conclude that GECC actually benefited from appellees' services."²⁵⁶ That is, given the fact that GECC was substantially oversecured at the start of the case and could have been paid in full, how could it be said that the work of the debtor's lawyers benefited GECC, within the meaning of section 506(c)?²⁵⁷ A number of courts have followed this lead and ruled that there can be no 506(c) recoveries in this circumstance.²⁵⁸

254. *In re Flagstaff Foodservice Corp.*, 29 B.R. 215, 217 (Bankr. S.D.N.Y. 1983).

255. *Id.* at 220.

256. *Levin & Weintraub*, 739 F.2d at 76.

257. This precise point is argued contrarily in *In re AFCO Enterprises, Inc.*, 35 B.R. 512 (Bankr. D. Utah 1983), a case discussed *infra* in the text accompanying notes 273-78. There, Judge Clark wrote: "The court rejects [the secured creditor's] interpretation of benefit; it is too narrow. The definition of benefit encompasses more than the bottom line of a balance sheet. Preservation of the going concern value of a business can constitute a benefit to the secured creditor." *Id.* at 515 (citing *Communication & Studies Int'l, Ltd. v. Bank of Am., N.T. & S.A. (In re World of English, N.V.)*, 21 B.R. 524 (Bankr. N.D. Ga. 1982); *Ford Motor Credit Co. v. Jim Kelly Ford, Ltd. (In re Jim Kelly Ford, Ltd.)*, 14 B.R. 812 (Bankr. N.D. Ill. 1980)).

258. See *Brookfield Prod. Credit Ass'n v. Borron*, 738 F.2d 951, 953 (8th Cir. 1984); *Sable v. Liberty Sav. Bank (In re Blue Ridge Motel Assocs.)*, 126 B.R. 477, 480-81 (Bankr. W.D. Pa. 1991) (Fitzgerald, J.); *Guy v. Grogan (In re Staunton Indus.)*, 75 B.R. 699, 702 (Bankr. E.D. Mich. 1987). In *Borron*, the value of the collateral—a flock of turkeys—had deteriorated since the petition was filed. 738 F.2d at 952. The debtor fattened the turkeys for the Thanksgiving Day market and eventually sold them. *Id.* at 952-53. The debtor was denied § 506(c) compensation for turkey feed because the benefit to the secured creditor was merely indirect. *Id.* at 954 (Bright, J., dissenting). Apparently we are to believe that fending off the starvation of livestock is merely an abstract or indirect benefit to the secured creditor.

For a case where the trustee was denied the expense of feeding hogs because the reorganization was unsuccessful, see *In re Combined Crofts Corp.*, 54 B.R. 294 (Bankr. W.D. Wis. 1985), where Judge Martin stated:

The expenses in question have not been proved to be necessary. The debtor was under no obligation to continue hog raising operations in order to protect [the se-

These decisions amount to a rule that the trustee must preserve debtor equity for the purpose of covering section 506(c) expenses—a view criticized earlier in this Article as extending the scope of secured claims generally beyond the amount by which they have been allowed.²⁵⁹ That is, where a debtor equity once existed and now does not, these courts have blocked section 506(c) charges. This result implies that the trustees should have preserved debtor equity for any charges that might have accrued.

Furthermore, Judge Van Graafeiland rejected the idea that GECC had consented to be charged under section 506(c): "Although a secured creditor may consent to bearing the costs of professional fees incurred by a debtor in possession, 'such consent is not to be lightly inferred.'" ²⁶⁰

The withholding-tax claim was also denied,²⁶¹ in spite of some facts that threw the Flagstaff officers into a sympathetic light. In order to fund the Chapter 11 bankruptcy, Flagstaff borrowed the funds needed to keep the doors open. In its statement of expenses to GECC, the officers accidentally listed the net payroll figures, not the gross figures. As a result, GECC, which might have lent more, lent just enough to pay the take home pay but not enough to pay the withholding taxes.²⁶²

This omission cut no ice with Judge Van Graafeiland. He wrote:

Appellees contend that the value ascribed to GECC's collateral as of the commencement of the Chapter 11 proceedings was based on a going concern valuation of the assets and that Flagstaff's reorganization attempt helped preserve most of this value. Assuming for the argument that this is so, it does not suffice to warrant section 506(c) recovery. The debtor in possession also must show that its funds were expended primarily

cured creditor's] interest in the hogs. Rather, operations were continued in order that the debtor could attempt to reorganize, an endeavor that regrettably proved unsuccessful. Under these circumstances the costs attendant upon the debtors' attempt to reorganize may not be charged to the secured party.

... In order to make this showing the debtors would have needed to prove that the net yield of their 1985 hog liquidations was greater than the net yield that [the secured creditor] would have received had it liquidated the hogs at the first available opportunity in 1984.

Id. at 298; *cf. In re Hollie*, 42 B.R. 111, 120-22 (Bankr. M.D. Ga. 1984) (Hershner, J.) (refusing to let dairy farmer use cash collateral unless the collateral itself were adequately protected, though § 506(c) is not mentioned, nor is the purpose of the debtor-in-possession's expenditure of cash).

259. See *supra* text accompanying notes 31-39.

260. *Levin & Weintraub*, 739 F.2d at 77 (quoting *In re S & S Indus.*, 30 B.R. 395, 398 (Bankr. E.D. Mich. 1983)).

261. *General Elec. Credit Corp. v. Peltz (In re Flagstaff Foodservice Corp.)*, 762 F.2d 10, 13 (2d Cir. 1985).

262. *Id.* at 11.

for the benefit of the creditor and that the creditor directly benefited from the expenditure. A debtor does not meet this burden of proof by suggesting possible or hypothetical benefits. Proof of direct benefits sought and received by GECC is completely lacking in this case.²⁶³

Thus, Judge Van Graafeiland ruled against the charge under section 506(c) because the expenses of administration such as payroll withholding taxes benefited the general creditors and had only an "incidental" benefit to the secured parties.²⁶⁴

Judge Van Graafeiland's opinions place a great deal of stress on the quantitative aspect of the word "benefit," which appears in section 506(c). Judge Van Graafeiland could not conceive of a Chapter 11 "benefiting" a secured creditor when the secured creditor started the proceeding oversecured and ended up being undersecured. That is, "benefit" must mean that the secured creditor is better off as a result of the trustee's action than without. We saw earlier, however, that this definition of "benefit," when coupled with a liquidation theory of value (wherein hypothetical transaction costs are deducted from the value of the collateral) reads section 506(c) out of the Bankruptcy Code.²⁶⁵

In contrast, although she specifically denied it,²⁶⁶ Judge Abram viewed the word "benefit" in qualitative, not quantitative, terms. Rather than scrutinizing the result—comparing what the secured creditor would have received given the trustee's intercession to what the secured creditor would have received on its own—Judge Abram simply inquired whether the *purpose* of Chapter 11 was, in part, to benefit the secured creditor. If the Chapter 11 proceeding did result in a great deal of liquidation into cash of hard assets, and if those cash proceeds were used to pay down a great deal of the secured debt, Judge Abram thought that the Chapter 11 "benefited" the secured creditor.

In *Flagstaff*, the bankruptcy judge and the Second Circuit had different ideas about what constitutes a "benefit" to secured creditors. It is

263. *Id.* at 12.

264. *Id.* at 12-13; *accord* C.I.T. Corp. v. A & A Printing, Inc., 70 B.R. 878, 881 (M.D.N.C. 1987) (Bullock, J.) (rent expenses for building where printing press was housed); *In re Bellman Farms, Inc.*, 86 B.R. 1016, 1021 (Bankr. D.S.D. 1988) (Ecker, J.) (accruing senior tax liens cannot be charged to a secured creditor under § 506(c)).

265. *See supra* text following note 162.

266. Judge Abram perceived herself as following a *quantitative* interpretation of the word "benefit." *In re Flagstaff Foodservice Corp.*, 29 B.R. 215, 219 (Bankr. S.D.N.Y. 1983). Citing the millions that GECC was actually paid, she wrote, "While often its interpretation rests upon subjective standards, benefit to the secured creditor must be shown in the quantitative, not qualitative or generalized sense." *Id.* (citing *Dozoryst v. First Nat'l Sav. & Loan Ass'n*, 21 B.R. 392, 394 (D. Ill. 1982) (Shadur, J.)).

not clear whether the appeals court viewed itself as reviewing findings of fact or findings of law. If the former, then Judge Abram's findings were entitled to the usual respect appellate courts give triers of fact. In *New Orleans Public Service, Inc. v. First Federal Savings & Loan Ass'n (In re Delta Towers, Ltd.)*,²⁶⁷ the Fifth Circuit made clear that these were findings of fact and, accordingly, gave the bankruptcy judge great latitude in failing to find any benefit to the secured creditor.²⁶⁸ In *Delta Towers*, a utility company claimed that its services helped preserve a hotel for a real estate mortgagee who also claimed fixtures and furniture.²⁶⁹ The mortgagee did not have a lien on cash proceeds from the hotel business, which in any case was not operating during the period in question.²⁷⁰ Judge Johnson sustained the bankruptcy court's finding that the utility company had not benefited the secured creditor within the meaning of section 506(c).²⁷¹ Such a holding is consistent with the theory presented in this Article—that secured creditors who do not own the income stream should not be charged with its maintenance.²⁷²

2. Cases That Make the Secured Creditors Pay

Some courts have not resisted the temptation to make the secured creditor pay section 506(c) expenses when otherwise the trustee must go uncompensated. In *re AFCO Enterprises*²⁷³ is a leading example of this genre. In *AFCO* Judge Glen Clark wrote:

While as a general rule, secured creditors should not be charged with the expenses of administration, the courts have carved out an exception based upon the equitable doctrine of unjust enrichment. When the secured creditor is the only entity which is benefitted by the trustee's work, it should be the one to bear the expense . . . where there is no corresponding benefit to the unsecured creditors.²⁷⁴

In *AFCO* the collateral was a resort hotel. A trustee ran the resort for a

267. 924 F.2d 74, 77 (5th Cir. 1991) (Johnson, J.).

268. *Id.* at 78; accord *Equitable Gas Co. v. Equibank, N.A. (In re McKeesport Steel Castings Co.)*, 799 F.2d 91, 93 (3d Cir. 1986) (Higginbotham, J.) (clearly erroneous standard of appellate review applies to the bankruptcy court sitting as the fact finder, but not to the district court).

269. *Delta Towers*, 924 F.2d at 75-76.

270. *Id.* at 77-78.

271. *Id.* at 79.

272. See also *Hospitality, Ltd. v. Fidelity Sav. & Loan Co. (In re Hospitality, Ltd.)*, 86 B.R. 59, 61-62 (Bankr. W.D. Pa. 1988) (Markovitz, J.) (secured parties did not pay, but unclear who owned income stream).

273. 35 B.R. 512 (Bankr. D. Utah 1983) (Clark, J.).

274. *Id.* at 515.

few months and then gave up. The resort was abandoned to the secured lender, who sold the property to itself by bidding in its secured claim. The trustee then tried to charge the secured creditor with maintenance expenses incurred during the trusteeship.²⁷⁵ Judge Clark considered, but rejected, a hypothetical exercise whereby the secured creditor would pay the expenses the secured creditor would have had to bear if no bankruptcy had ensued.²⁷⁶ Instead, Judge Clark, emphasizing the need to protect the trustee's business judgment, insisted on charging the secured creditor with the trustee's maintenance expense.²⁷⁷

In *AFCO* it was not clear whether the income stream belonged to the estate or to the secured creditor. If the debtor-in-possession owned the income stream,²⁷⁸ then, according to the theory advocated in this Article, the secured creditor should not pay to maintain it. On these facts, the secured creditor would have been denied adequate protection of its security interest when the hotel was charged with the expense of maintaining the income stream. On the other hand, if the hotel receipts were cash proceeds belonging to the secured creditor, then expenses for

275. *Id.* at 513-14.

276. *Id.* at 515.

277. *Id.* at 517-18. One argument the secured creditor made was that, in spite of the "maintenance expense," the collateral decreased in value during the time the trustee was in charge. This fact was used to prove that the expenses did not "benefit" the secured creditor as § 506(c) requires. Judge Clark rejected this proof and instead protected the trustee's business judgment. *Id.* at 515-16.

For another case that was generous to the trustee when a floating lien encumbered all assets including the income stream, see *In re Bob Grissett Golf Shoppes, Inc.*, 50 B.R. 598, 606-07 (Bankr. E.D. Va. 1985) (Bostetter, J.); see also *Communication & Studies Int'l, Ltd. v. Bank of Am., N.T. & S.A. (In re World of English, N.V.)*, 21 B.R. 524, 527 (Bankr. N.D. Ga. 1982) (Drake, J.) (reading pre-Code cases as a "progression . . . providing a liberal interpretation to the determination of what constitutes the preservation of property in which a secured creditor has an interest"). Judge Drake went on to remark, "It seems to this Court that merely keeping a debtor in operation may constitute preservation of property." *Id.* at 527. Thus, performance of services for customers rendered accounts receivable collectible, justifying the imposition of § 506(c) expenses. *Id.* at 528.

278. Some cases hold that hotel receipts are not rents encumbered by a real estate mortgage, but Article 9 accounts receivable. If a mortgagee does not perfect her security interest under Article 9, the cash flow is disencumbered and belongs free and clear to the bankrupt estate. *In re Nendels-Medford Joint Venture*, 127 B.R. 658, 668-69 (Bankr. D. Or. 1991) (Higdon, J.); *In re Ashoka Enters., Inc.*, 125 B.R. 845, 846 (Bankr. S.D. Fla. 1990) (Kahn, J.); *In re Oceanview/Virginia Beach Real Estate Assoc.*, 116 B.R. 57, 59 (Bankr. E.D. Va. 1990) (Bonney, J.). Even if the mortgagee does perfect under Article 9, the receivables might be deemed to be proceeds of a service offered by the hotel, rather than proceeds of the real estate itself. If so, Bankruptcy Code § 552(a) disencumbers any postpetition hotel receivables from the prepetition after-acquired property clause. See Craig H. Averch, *The Heartbreak Hotel for Secured Lenders: When Postpetition Revenue From a Hotel Is Not Subject to a Prepetition Security Interest*, 107 BANKING L.J. 484, 487-94 (1990).

managing the cash flow were properly chargeable to the secured creditor under section 506(c).

A case with almost identical facts is *In re P.C., Ltd.*,²⁷⁹ in which the secured creditor also was saddled with section 506(c) liability. Whereas *AFCO* involved abandonment of an income-producing property, *P.C.* involved an asset payment. That is, the debtor transferred the collateral (as in *AFCO*, a hotel) directly to the secured creditor in exchange for extinguishing of the secured creditor's claim.²⁸⁰ Like *AFCO*, it is not clear who owned the income stream from the hotel prior to the sale. If the income stream belonged to the debtor-in-possession, the debtor-in-possession should have paid the ordinary expenses of hotel management prior to the transfer to the secured creditor. If the security agreement reserved income to the secured creditor pending the sale, then such expenses should be chargeable to the secured creditor under section 506(c).

The *P.C.* case has an added wrinkle. All the expenses charged to the secured creditor were incurred *after* the Chapter 11 plan was confirmed.²⁸¹ Judge Arceneaux ruled this fact irrelevant in applying section 506(c) to the detriment of the secured creditor.²⁸² Yet section 506(c) cannot justify charges to the secured creditor after confirmation. A Chapter 11 plan constitutes the sum total of the legal relations between a debtor and its creditors, once the plan is confirmed. Of necessity, a plan will include the division of an undersecured creditor's claim into its secured and unsecured parts.²⁸³ Charging the secured creditor with post-confirmation expenses has the effect of lowering the secured claim, and it ought to have the concomitant effect of raising the unsecured claim.²⁸⁴ Yet the unsecured claim is fixed in the plan. Therefore, the court's deci-

279. 110 B.R. 232 (E.D. La. 1990) (Arceneaux, J.).

280. *Id.* at 233-34. The difference between an abandonment and an asset payment can be further elucidated as follows. In an abandonment, the trustee simply renounces her rights to the collateral. The collateral then reverts to whomever had property interests prior to the bankruptcy. See 11 U.S.C. § 554 (1988). Under abandonment, the secured creditor takes a security interest (governed by Article 9 or other relevant law), and the debtor retakes the equity. Article 9, of course, requires the secured creditor to hold a sale.

In an asset payment, the trustee conveys the debtor equity to the secured creditor. The secured creditor now has a combined security interest and debtor equity, which merge together to form absolute ownership. Now Article 9 does not apply, and the secured creditor is no longer required to sell.

281. *P.C.*, 110 B.R. at 234.

282. *Id.* at 236.

283. This division occurs unless the secured creditor makes the perplexing § 1111(b) election. If so, the ceiling that § 506(a) sets on the secured claim is repealed. For details, see Carlson, *supra* note 155, at 288-303.

284. See *supra* text accompanying notes 66-79.

sion violates the secured creditor's rights under the plan.²⁸⁵

It seems apparent that in *P.C.* the secured creditor's secured claim was overvalued—the court failed to deduct foreclosure expenses from its valuation of the collateral correctly, or at all.²⁸⁶ But this mistake—perhaps corrigible before confirmation²⁸⁷—becomes etched in stone after confirmation. The unexpected maintenance expense that should not have been charged to the secured creditor should be viewed the same as a postconfirmation tort claim. That is, the postconfirmation claim impoverishes the equity holders of the debtor-in-possession, and then, after them, the unsecured creditors, but those who hold liens under the plan should be immune from such unsecured claims.

*In re Johnson*²⁸⁸ is a common sort of farm reorganization case in which the debtors requested use of cash collateral for everyday working capital.²⁸⁹ Judge Martin permitted such use, without compensation to the secured creditor, on the theory that the money would be used to maintain the value of cattle, which were also collateral for the secured creditor.²⁹⁰ But here the entire income stream (the proceeds of milk from the cows) belonged to the secured creditor, so that the charge was appropriate.²⁹¹ Curiously, in the same year the same Judge Martin refused to compensate a farmer for feeding hogs in *In re Combined Crofts Corp.*²⁹² The distinction between the cases may lie in the fact that, in *Johnson* the reorganization still seemed feasible,²⁹³ whereas in *Crofts* the

285. Modification of a plan is possible after confirmation only if the plan is not "substantially consummated," a term undefined by the Bankruptcy Code. See 11 U.S.C. § 1127(b) (1988 & Supp. 1991). In *P.C.* the major asset was the hotel, and it had already been transferred to the secured creditor. *P.C.*, 110 B.R. at 233. Therefore, it seems as if the plan was substantially consummated and could no longer be modified. See also 11 U.S.C. § 1141(c) ("[E]xcept as otherwise provided in the plan . . . after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor."). Arguably, the *P.C.* decision violates this provision as well.

For another case allowing some § 506(c) charges after confirmation, see *Settles v. United States (In re Settles)*, 75 B.R. 229, 230-31 (Bankr. C.D. Ill. 1987) (Altenberger, J.).

286. *P.C.*, 110 B.R. at 235-36.

287. On the power of the bankruptcy court to correct bad valuations, see *Carlson*, *supra* note 155, at 258-72.

288. 47 B.R. 204 (Bankr. W.D. Wis. 1985) (Martin, J.).

289. *Id.* at 206.

290. *Id.* at 207-09.

291. *Id.* at 207-08. For a case that easily granted the debtor the expenses of harvesting crops planted prepetition (but refused the cost of planting unencumbered postpetition crops), see *First National Bank v. Hamilton (In re Hamilton)*, 18 B.R. 868, 873 (Bankr. D. Colo. 1982) (McGrath, J.). Cases in which farmers were denied recompense for feeding the secured creditor's livestock are gathered *supra* note 258.

292. 54 B.R. 294, 298 (Bankr. W.D. Wis. 1985), discussed *supra* note 258.

293. *Johnson*, 47 B.R. at 209 ("While the Johnsons have demonstrated a willingness to

reorganization was not working.²⁹⁴

*Equitable Gas Co. v. Equibank, N.A. (In re McKeesport Steel Castings Co.)*²⁹⁵ is a case that half-follows the theory presented earlier. In *Equitable Gas* the collateral was sold as a going concern. One secured creditor claimed inventory and receivables (that is, the income stream) while the other claimed equipment, fixtures, and real estate. The latter creditor obviously did not own the income stream. Yet both had to pay the utility company for energy provided prior to the sale.²⁹⁶ Significantly, the secured creditors had already agreed to a cash-collateral order for the purpose of paying the utility company, but apparently the debtor-in-possession diverted the funds for some other purpose.²⁹⁷ In a sense, the secured creditors were made to pay twice for the same services.²⁹⁸

Even worse in this very regard is *In re Kain*,²⁹⁹ which stands as a warning against too much generosity and compassion by undersecured parties to their debtors. In *Kain* the undersecured creditor claimed a security interest in, among other things, hogs and related cash proceeds. After the bankruptcy petition, cash proceeds had accumulated from the sale of hogs. The secured creditor consented to the debtors taking seventy-five percent of the cash for everyday expenses on the farm, with the remaining twenty-five percent being paid to the secured creditor in order to reduce the outstanding debt.³⁰⁰

When it came time to confirm the Chapter 11 plan, the debtor tried to deduct the expenses of feeding the hogs under section 506(c), thereby reducing the amount of the secured creditor's entitlements under the

effectuate a plan of reorganization, I cannot determine whether an effective reorganization is probable without a proposed plan. Use of the milk proceeds at this point, however, makes it more likely that a plan will be effectuated and that there will be a stream of future milk proceeds in which the creditors will still hold security interests.").

294. See *Crofts*, 54 B.R. at 297-98, discussed *supra* note 258.

295. 799 F.2d 91 (3d Cir. 1986) (Higginbotham, J.).

296. *Id.* at 94-95. It is also not clear from Judge Higginbotham's opinion whether any debtor equity existed. This Article has argued that § 506(c) awards are appropriate *only* when no equity exists. See *supra* text accompanying notes 12-39. In that the sale in *Equitable Gas* was a sale of the entire going concern, the bankruptcy court must have assigned a share of the proceeds to the collateral sold according to some accounting assumptions that are not disclosed. These assumptions would influence heavily the existence or not of an equity cushion.

297. *Equitable Gas*, 799 F.2d at 92.

298. *Id.* at 94-95. The secured creditors' consent to pay the utilities, only to have the money diverted elsewhere, was actually used against them. The earlier consent was held to be consent to pay again, this time more efficaciously. *Id.* at 94. Obviously, this seems rather unfair. At a minimum, the responsible parties should be made to re-compensate the secured parties for the defalcation of the cash collateral.

299. 86 B.R. 506 (Bankr. W.D. Mich. 1988) (Gregg, J.).

300. *Id.* at 509-10.

Chapter 11 plan.³⁰¹ Judge Gregg's opinion is not clear on this point, but it is likely that the expenses of feeding the hogs had already been covered by cash proceeds belonging to the secured creditor. If so, trying to charge the secured creditor with the same expense again at the time of confirmation of the plan constitutes unacceptable double-charging. But if the feeding expenses had been covered by unencumbered cash, the secured creditor ought to have reimbursed the trustee for these expenses.

The court's theory seemed to be that the secured creditor had waived its right to the security interest on the cash.³⁰² Hence, the dollars were indeed unencumbered when the trustee paid them to satisfy debts related to feeding the hogs. And since unencumbered dollars went to satisfy a 506(c) expense, the trustee was now entitled to recover this expense from the secured creditor.³⁰³ It is hard to believe the secured creditor waived its security interest on cash in this way. Waiver, of course, is supposed to be knowing and voluntary. Yet, according to Judge Gregg, the secured creditor knowingly agreed to be double charged for 506(c) expenses.³⁰⁴

Although the *Kain* court might have found that the 506(c) expenses should have been covered already by the seventy-five percent donated to the debtor, the court sought to redress the unfairness. The secured creditor had been undersecured.³⁰⁵ The court therefore ruled that the payments received by the secured creditor should reduce the *unsecured* portion of the debt, leaving the secured portion undisturbed.³⁰⁶

This concession, however, was meaningless. If nonproceeds had been paid to the secured creditor, then a decision that reduces the unsecured portion of the claim would benefit the secured creditor greatly. But when the secured creditor has received cash collateral, not only does the total claim diminish, but some of the collateral disappears (unless it is somehow replaced).³⁰⁷ For example, suppose the secured creditor's total

301. *Id.* at 507-08.

302. *Id.* at 516-18.

303. *Id.* at 512-14, 518.

304. *Id.* at 512.

305. *Id.* at 510-11, 514.

306. *Id.* at 515.

307. *Accord* John Fabick Tractor Co. v. Maun (*In re Maun*), 95 B.R. 94, 96 n.4 (Bankr. S.D. Ill. 1989) (Meyers, J.) (criticizing the *Kain* case). In *Maun* an undersecured creditor received unencumbered dollars. Judge Meyers held this to be a paydown of the secured portion of the claim. As a result, the debtor had equity in the property and the stay would not be lifted under Bankruptcy Code § 362(d)(2)(A). *Id.* at 95-96. One may also ask whether this new-found debtor equity entitled the secured creditor to postpetition interest under § 506(b). For the view that § 506(b) awards under such conditions are inappropriate, see *In re Broomall Printing Corp.*, 131 B.R. 32, 35-37 (Bankr. D. Md. 1991) (Derby, J.); Carlson, *supra* note 21, at 387-94.

claim was \$100. The hogs are worth \$75 and there is \$10 cash collateral, so that the secured portion of the claim is \$85 and the unsecured portion is \$15. The secured creditor is then given the \$10 cash collateral. After that payment, the total claim is \$90, but only \$75 in total collateral exists. The secured creditor inevitably has a \$15 unsecured deficiency before and after payment. Applying the cash collateral to reduce the unsecured deficit was therefore a useless gesture.³⁰⁸ If the court wanted to reduce the unsecured deficiency, it would have been necessary to give the secured creditor noncollateral as payment, which was not done.³⁰⁹

3. Summary

As the previous two sections have demonstrated, the case law regarding section 506(c) expenses in reorganization cases is in disarray. Cases such as *Flagstaff Foodservices* are implacably hostile to the idea that secured creditors might be made to bear the expenses of operating a firm during reorganization. Other cases, such as *AFCO*, are sympathetic. These cases have no apparent theme or order to them. This Article suggests the cases should be divided between those in which a security interest encumbers the income of a firm and cases in which the income is unencumbered. Section 506(c) should apply to the first, but not to the second, type of case. Even when income is unencumbered, the secured creditor should bear the same preservation or maintenance expenses that would have been borne by the creditor if there had never been a bankruptcy proceeding. These rules are consistent with the nature of rational

308. Because the value of the hogs stayed constant (whether by new births, more value per prepetition hog, replacement through expenditure of cash collateral, or replacement through expenditure of estate funds), Judge Gregg implied that the secured creditor already was protected adequately for the duration of the case and therefore did not deserve the cash payments. *Kain*, 86 B.R. at 513-14.

This observation is based on a confusion. The secured creditor already owned the cash collateral it had been given during the pendency of the Chapter 11 proceeding. No one was claiming that such payments were to compensate for the deterioration in the value of the collateral. If the secured creditor were entitled to cash payments because of depreciation, then the payments should never be from cash collateral, because such payments further depreciate the collateral available to the secured creditor. Rather, adequate protection payments may only be by means of unencumbered dollars. Second, even if the market price of the hogs stayed constant, the value of the hogs to the secured creditor declined to the extent section 506(c) expenses accrued.

In any case, the purpose of this observation is far from clear. Judge Gregg had already ruled that the secured creditor was not entitled to adequate protection because it failed to ask for it. *Id.* at 512. Given that adequate protection was inappropriate for this reason, Gregg did not need to observe a steady value of collateral over time.

309. *Cf. In re Canaveral Seafoods, Inc.*, 79 B.R. 57, 58-59 (Bankr. M.D. Fla. 1987) (Proctor, J.) (refusing to allow undersecured creditor to characterize nonproceeds as postbankruptcy interest and insisting on treating them as payment on the secured portion of the claim).

secured lending, in which income is expected to cover maintenance of the collateral and debt service to the lender.

IV. CONCLUSION

The relationship between adequate protection of secured creditors and trustee expenses under section 506(c) is profoundly complicated. The two are mirror opposites. On the one hand, adequate protection preserves the collateral from being used or spent in the administration of the bankrupt estate. On the other hand, section 506(c) subjects the collateral to just these expenses. Section 506(c) itself suggests the mediating principle—that expenses under section 506(c) must *benefit* the secured creditor. Because this single phrase is meaningless unless some content is provided, this Article has attempted to separate expenses that may be charged to the secured creditor under section 506(c) from expenses which the bankrupt estate should bear on its own. This is particularly difficult in reorganization cases, in which the collateral may never be sold. The principle for distinguishing between preservation expenses chargeable under section 506(c) and those not chargeable is the idea that income-producing property should be self-supporting and should be sufficient to cover debt service. This principle implies that, when the income stream is part of the collateral, the secured creditor should bear the expense of maintaining the income stream under section 506(c). When the debtor owns an unencumbered income stream, the debtor should bear the cost of maintaining the collateral. This rule provides a rational way to allocate expenses when no unencumbered assets remain in a Chapter 11 estate.

