



Bankruptcy & Financial Restructuring ADVISORY ■

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Secured Creditors Must Be Diligent to Protect Post-Petition Interest and Costs

U.S. District Judge Louise W. Flanagan recently affirmed a ruling from the U.S. Bankruptcy Court for the Eastern District of North Carolina in *In re Construction Supervision, Inc.*¹ that a secured creditor that was oversecured on the date the debtor filed for bankruptcy was not entitled to a superpriority administrative expense claim under 11 U.S.C. § 507(b) for post-petition interest, costs or fees.

Background

When Construction Supervision Services, Inc. (the debtor) filed its voluntary Chapter 11 petition on January 24, 2012, the secured creditor held claims against the estate totaling \$1,265,868.55, including principal and matured interest as of the petition date (the “secured claim”). The secured claim was oversecured as of the filing because it was secured by the debtor’s accounts receivable, which were valued at over \$5 million as of the petition date.

During the course of the case, the court granted various motions related to the secured claim, including authorizing the use of cash collateral and ordering the debtor to pay the secured creditor adequate protection payments. The debtor made both credits and debits to its accounts receivable during the course of the case. Two months after the case was filed, the court allowed various subcontractors and material providers (the “subcontractors”) who had not perfected their liens prior to the petition date to perfect them post-petition. As a result, these now-perfected liens took priority over the secured claim under North Carolina law.

On October 1, 2012, the debtor voluntarily converted the case to Chapter 7. Thereafter, the Chapter 7 trustee liquidated the debtor’s assets and paid the secured creditor \$1,237,836.79, which, when added to the adequate protection payments it had already received, resulted in a total of \$1,300,736.79 paid to the secured creditor.²

¹ *Branch Banking and Trust Company v. Stephen L. Beaman (In re Construction Supervision)*, No. 5:15-cv-434 (E.D.N.C. May 9, 2016).

² Although not explicitly stated in either the district court or bankruptcy court opinions, this amount likely constituted the remaining balance of the accounts receivable following the debtor’s use of the accounts receivable during the debtor-in-possession period and following the trustee’s distributions to the subcontractors.

Because the payment did not fully satisfy the secured creditor's claim for *post-petition* interest, costs and fees, the secured creditor filed a motion in the bankruptcy court requesting a superpriority administrative expense pursuant to 11 U.S.C. § 507(b) and alternatively, a motion to recover post-petition interest, costs and fees pursuant to 11 U.S.C. § 506(b).

Court Rulings

The bankruptcy court denied both motions. On appeal, the district court held that the secured creditor was not entitled to superpriority status because (1) the adequate protection payments provided to the secured creditor were not "inadequate" where the secured creditor fully recovered the principal debt and interest owed to it as of the petition date; (2) the secured creditor failed to address the effect the intervening subcontractors' liens had on its claim; (3) the secured creditor did not demonstrate that its collateral declined in value as a result of the debtor's beneficial use of such collateral during the debtor's Chapter 11 case; and finally (4) the secured creditor was not entitled to recovery for any diminution in the value of the collateral securing the debtor's obligation that occurred following the debtor's conversion of its case to Chapter 7.

Addressing the first point, the court held that the relevant "interest" to be protected under 11 U.S.C. § 507(b) is the value of a creditor's secured claim on the petition date, not the value of the collateral. The court reasoned that because the secured creditor received more from the estate than the value of its secured claim on the petition date, it had been adequately protected.

In the alternative, the court held that even if the "interest" to be protected under 11 U.S.C. § 507(b) is the value of the collateral instead of the value of the secured claim, the secured creditor had failed to prove that the diminution in the value of the debtor's collateral was attributable solely to the debtor's use of property *prior* to the conversion of the case from Chapter 11 to Chapter 7.

The court explained that "[a] superpriority claim only exists where the decline in the collateral's value is attributable to an administrative expense," i.e., the debtor must have used the collateral to "pay the actual, necessary costs and expenses of preserving the estate." The court stated that any diminution in value that occurred *after* the case was converted to Chapter 7 could not be characterized as an administrative expense because "the mere opportunity to market collateral is [not] the type of concrete, actual benefit contemplated by § 503(b)." The district court affirmed the bankruptcy court's holding that the secured creditor had failed to show that the diminution in value of the collateral was caused by the debtor's use of the property "[b]ecause [the secured creditor] did not demonstrate the value of the debtor's accounts receivable at the time of conversion."

Addressing the secured creditor's claim for post-petition interest, fees, costs and expenses under 11 U.S.C. § 506(b), the court held that because the secured creditor had failed to prove what portion of the funds collected on the debtor's accounts receivable prior to the conversion to Chapter 7 were unencumbered by senior liens, the secured creditor had failed to bear its burden to show the extent of its oversecured position for purposes of § 506(b), and therefore could not recover under the section.

Takeaway

Construction Supervision should serve as a warning to secured creditors that they may not be able to use Section 507(b) to recoup post-petition interest, fees and expenses in addition to the value of their secured claim at the time a debtor files for bankruptcy. The case also highlights the necessity for creditors to support their claims with a detailed factual record and documentation or other evidence to support those facts. Here, the secured creditor was precluded from recovering under Section 506(b) because the secured creditor failed to prove what portion of the funds collected from the debtor's accounts receivable during the debtor-in-possession period was unencumbered by the subcontractors' liens.

Creditors that are oversecured on the petition date should work diligently throughout the pendency of the case to protect their interests, including seeking significant adequate protection payments and objecting to any other creditor's effort to perfect liens on the property of the estate post-petition. Creditors should also ensure that the debtor meets all reporting requirements throughout the pendency of the case and carefully monitor their collateral to ensure that when the time comes, the creditor can meet its burden of showing the extent of its oversecured position necessary for a recovery under 11 U.S.C. § 506(b).

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