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Supreme Court Rules in 'Hartford' Bankruptcy Case

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The Supreme Court's recent decision in *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.*,[1] resolves a split among the circuits and will have important repercussions for creditors who do business with Debtors-in-possession or bankruptcy trustees, such as insurance companies, utilities, trade creditors, landlords, and others.

In *Hartford Underwriters*, Hartford Underwriters Insurance Company (Hartford) had insured Hen House Interstate, Inc. (the Debtor) for its workers' compensation coverage during its Chapter 11 reorganization proceedings. The Debtor failed to make required monthly premium payments, but rather than cancel the policy or seek other relief, Hartford continued to provide the Debtor with insurance.

The case was subsequently converted to a Chapter 7 liquidation and a trustee was appointed. At the time of conversion, the Debtor owed Hartford more than $50,000 in unpaid premiums. Hartford, which only learned that the Debtor was in bankruptcy after the conversion, then applied to the Bankruptcy Court for payment of its unpaid premiums as an expense of the Debtor's administration, with priority ahead of the Debtor's prepetition unsecured claims.

However, essentially all of the Debtor's assets were subject to a security interest in favor of its prepetition lender, Union Planters Bank (the bank), securing debts to the Bank in excess of $4 million. In addition to prepetition lending to the Debtor, with Bankruptcy Court approval, the bank also made a $300,000 postpetition loan to the debtor. In connection with the postpetition lending, the bank further stipulated to the Debtor's use of cash collateral subject to bank's security interest to pay expenses set forth in a budget attached to the Bankruptcy Court approved financing order, which budget included a line item for workers' compensation insurance.

As a result of the bank's blanket security interest on all of the Debtor's real and personal property, the Debtor's estate lacked unencumbered funds with which to pay Hartford the insurance premiums it sought. Thus, Hartford sought to surcharge the bank's collateral under §506(c)[2] of the Bankruptcy Code (Code).[3]

The Bankruptcy Court and District Court both permitted such surcharge of the bank's collateral on the grounds that, under applicable Missouri law, Debtor was obligated to maintain workers' compensation insurance and that the bank had consented to the insurance compensation expense in connection with its postpetition lending.

Eighth Circuit

On appeal to the U.S. Court of Appeals for the Eighth Circuit , the bank asserted that Hartford lacked standing to surcharge its collateral, as the language of the statute specifies that the "trustee" has the ability to surcharge a secured creditor's collateral, not creditors.

However, the three judge panel held that only an en banc panel could overrule the prior controlling decision of the Eighth Circuit in *IRS v. Boatman's First Nat'l Bank*,[4] which held that a creditor had standing to surcharge a creditor's

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collateral when such creditor, other than being a trustee, met the requirements of §506(c).[5]

Subsequently, the entire Eighth Circuit en banc reviewed the issue of whether Hartford had standing to surcharge the bank's collateral under §506(c) and reversed, subject to vigorous dissent.[6]

The Supreme Court granted certiorari and unanimously affirmed in a relatively short opinion delivered by Justice Scalia. The Court found that "the statute appears quite plain in specifying who may use §506(c) — '[t]he trustee.' "[7]

The Court contrasted the reference to the "trustee" in §506(c) with the broad phrasing of other sections of the Code, such as §502(a) which provides that a claim is allowed unless a "party in interest" objects, and §503(b)(4) which allows an "entity" to file a request for payment of an administrative expense.[8]

The Court also rejected Hartford's argument that the lack of restrictive language in the section, such as contained in §§109(a)[9] and 707(b)[10] of the Code, indicates that §506(c) was not meant to be limited to trustees.[11]

While the Court recognized that the provision in §506(c) for the charge of certain administrative expenses against lienholders continues a practice that existed prior to the enactment of the Code, under the Bankruptcy Act of 1898,[12] the Court found that "[i]t is questionable whether these precedents establish a bankruptcy practice sufficiently widespread and well recognized to justify the conclusion of implicit adoption by the Code"[13] and concluded "[i]n this case, we think the language of the Code leaves no room for clarification by pre-Code practice."[14]

The Supreme Court also rejected Hartford's policy argument that creditors must be permitted to pursue §506(c) recovery in appropriate cases because otherwise in cases where the trustee does not have available funds to pay the claimant, the trustee has no economic incentive to seek a recovery under §506(c) for amounts that will be paid over to the claimant, thus the secured creditor may obtain a windfall at the expense of the unpaid claimant.[15]

The Court found that limiting §506(c) to the trustee does not leave creditors who provide post-petition goods or services that may benefit the secured creditor without protection: they may insist on cash payment, contract directly with the secured creditor, and may be able to obtain an order of the Bankruptcy Court granting them a superpriority under §364(c)(1) or a security interest under §§364(c)(2), (3) or 364(d).[16]

Finally, the Court chided Hartford for failing to monitor the status of its account.

Conclusion

Aside from marking a change in the established law in four circuits,[17] the *Hartford* decision is extremely important to creditors doing business with debtors-in-possession or trustees in bankruptcy cases where all of the assets of the debtor's estate are subject to secured creditors' liens. In many bankruptcy cases it is quite common to find that the debtor has few, if any, unencumbered assets.

With the unavailability of §506(c) to creditors, careful policing by creditors of their debtors assumes added importance. Hartford did not become aware of the Debtor's bankruptcy filing until after the case was converted to Chapter 7. Had Hartford, for example, subscribed to a national credit reporting service that would have notified it automatically in the event of a bankruptcy filing by any of its customers, it could have learned much earlier and taken appropriate action.

The simplest solution for a creditor providing goods or services to a debtor-in-possession or a trustee of a bankruptcy estate that is fully encumbered by secured creditors' liens, would be to demand payment on a C.O.D. basis. If this is not possible, prior to providing the goods or services, the creditor should have competent bankruptcy counsel negotiate, and obtain Bankruptcy Court approval of, an appropriate stipulation with the debtor-in-possession or trustee, and other appropriate parties in interest (which may include one or more creditors' committees, secured lenders, and the U.S. Trustee's Office). Utilities have their own special remedy contained in §366, which permits them to require a security deposit as adequate assurance of payment or to terminate service.

(1) 2000 U.S. LEXIS 3624 (U.S. May 30, 2000).

(2) "*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." 11 U.S.C. §506(c) (emphasis added).

(3) 11 U.S.C. §101 et seq.

(4) 5 F.3d 1157 (8th Cir. 1993).

(5) 150 F.3d 868, 871 (8th Cir. 1998) ("*Henhouse I*").

(6) 177 F.3d 719 (8th Cir. 1999) ("*Henhouse II*") (Four out of the twelve judges hearing *Henhouse II* en banc dissented).

(7) 2000 U.S. LEXIS 3624, at *10.

(8) Id. at *12.

(9) Which contains the restrictive language "only a person". 11 U.S.C. §109(a).

(10) Which contains the restrictive language "...the court, on its own motion or on a motion by the United States trustee, but not at the request or suggestion of any party in interest...." 11 U.S.C. §707(b).

(11) 2000 U.S. LEXIS 3624, at *13.

(12) Id. at *15.

(13) Id. at *17.

(14) Id. at *18.

(15) Id. at *19 (This is also the position advanced by the dissent in *Henhouse II*, See 177 F.3d at 726).

(16) Id. at *21.

(17) See *North County Jeep & Renault, Inc. v. General Elec. Capital Corp. (In re Palomar Truck Corp.)*, 951 F.2d 229, 232 (9th Cir. 1991), cert. denied, 506 U.S. 821 (1992); *In re Parque Forestal, Inc.*, 949 F2d 504, 511 (1st Cir. 1991); *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); *Equitable Gas Co. v. Equibank N.A. (In re McKeesport Steel Castings Co.)*, 799 F.2d 91, 94 (3d Cir. 1986).