AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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On the Edge

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Impact of Marshaling and Surcharge Waivers at Plan Confirmation

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Bankruptcy court orders approving debtor-in-possession (DIP) financings in large corporate cases often include waivers of the equitable doctrine of marshaling. These waivers provide DIP lenders with discretion over the collateral from which they may first recover in the event of an exercise of remedies. Despite their prevalence, however, the rationale behind marshaling waivers, and the consequences of their inclusion in DIP orders, remain obscure. This article sheds light on the potential impact of marshaling waivers on the allocation of value under chapter 11 plans and discusses how marshaling waivers, in tandem with surcharge waivers, can help secured creditors maximize their recoveries under a chapter 11 plan.

The Doctrine of Marshaling and Marshaling Waivers

The equitable doctrine of marshaling "asserts that a senior-lien creditor with a right to proceed against more than one asset of a debtor must, in fairness, attempt to satisfy his claim(s) from assets that are not encumbered with junior liens."[2] It "rests upon the principle that a creditor having two funds to satisfy his debt may not, by his application of them to his demand, defeat another creditor, who may resort to only one of the funds."[3] For example, a debtor's senior-lien creditor has exclusive collateral (*i.e.*, assets over which only it has a lien) and collateral that it shares with a junior-lien creditor. The doctrine of marshaling would require the senior-lien creditor to seek to satisfy its debt from the exclusive collateral first before looking to the shared collateral, thereby preserving the shared collateral for the junior-lien creditor.

Some courts have described the doctrine of marshaling as fitting in neatly with the broader fundamental bankruptcy policy of maximizing distributions to an estate's creditors. By proceeding first against collateral unavailable to junior-lien creditors, "there are more funds available for distribution to other creditors of the common debtor, thus satisfying these claims to the maximum extent possible."[4] While this policy-based rationale holds true from the perspective of junior *secured* creditors, it does not from the perspective of *unsecured* creditors. Rather, the doctrine of marshaling ensures that collateral is distributed in a manner that maximizes the recovery of secured creditors, potentially to the detriment of unsecured creditors.

Surcharge Waivers

The marshaling waiver is best understood in conjunction with another provision that parties typically include in DIP orders: the surcharge waiver. In general, bankruptcy courts recognize that an estate's unencumbered assets should bear the cost of administering a chapter 11 case,[5] but surcharge is an exception to this general rule. Section 506(c) of the Bankruptcy Code allows a debtor to charge "the reasonable, necessary costs and expenses of preserving, or disposing of," a secured creditor's collateral to the collateral itself.

When the doctrine applies, the secured creditor whose collateral is being surcharged must contribute to the cost of administration, thus preserving unencumbered assets for the benefit of unsecured creditor recoveries. However, secured creditors often

1 This article represents the views of the authors, and the statements made herein are not those of their firm or its clients. The authors are grateful to **Max J. Linder** for his invaluable contributions.
2 *In re San Jacinto Glass Indus. Inc.*, 93 B.R. 934, 937 (Bankr. S.D. Tex. 1988).
3 *Meyer v. United States*, 375 U.S. 233, 236 (1963).
4 *San Jacinto Glass*, 93 B.R. at 937.
5 *See In re Hous. Reg'l Sports Network LP*, 886 F.3d 523, 533 (5th Cir. 2018) ("The general rule in bankruptcy is that administrative expenses cannot be satisfied out of collateral property, but must be borne out of the unencumbered assets of the estate.").

require that DIP orders include surcharge waivers, barring debtors from looking to collateral to fund their bankruptcy cases.

Who Benefits from Marshaling and Surcharge Waivers?

Marshaling waivers serve the interests of DIP lenders by eliminating a constraint on their exercise of remedies. If the debtor defaults, lenders can proceed against the collateral of their choosing — even collateral that, pre-petition, was encumbered by junior liens.

What about the effect of the marshaling waiver on other creditors? In general, marshaling serves the interests of junior-lien creditors to the detriment of unsecured creditors. Consider, as is common, a DIP facility that has a senior lien on the assets securing the debtor's pre-petition funded debt and a lien on certain previously unencumbered assets. If the DIP lenders seek to recover first from collateral that was unencumbered pre-petition, they maximize the collateral that remains available for junior-lien creditors. This result harms unsecured creditors, who will have less unencumbered value available to satisfy their claims.

Accordingly, marshaling waivers would appear to *benefit* unsecured creditors. Marshaling waivers leave open the possibility that DIP lenders will resort first to shared collateral, eroding the secured position of junior-lien creditors. Despite this, creditors' committees routinely object to marshaling waivers. The reason, in part, appears to be that creditors' committees believe that they can rely on the marshaling doctrine to compel a distribution of assets that favors unsecured creditors, but that is not the case. Marshaling is an equitable doctrine available only for the benefit of junior-lien creditors; unsecured creditors cannot invoke the doctrine, and courts have rejected attempts at "reverse" marshaling.[6]

Creditors' committees' challenges to marshaling waivers overlook another benefit that these waivers can provide unsecured creditors. When there is DIP financing in place, marshaling waivers provide unsecured creditors with a tool — albeit an indirect one — to force pre-petition secured creditors to bear the costs of administration: seeking repayment of the DIP from the proceeds of pre-petition collateral. In this way, marshaling waivers go hand-in-hand with surcharge under § 506(c), as each can have the effect of preserving unencumbered assets for the benefit of unsecured creditors. After all, DIP orders rarely prohibit repayment of the DIP from pre-petition collateral. Rather, marshaling waivers allow for this precise outcome. Thus, when a creditors' committee objects to a marshaling waiver, it challenges precisely the provision that might otherwise allow a debtor to charge estate costs to its pre-petition secured creditors.

However, objections from creditors' committees to marshaling waivers serve an important purpose. By objecting to these waivers, creditors' committees plant stakes in the ground regarding whether secured or unsecured creditors will bear the costs of a bankruptcy proceeding — an issue that will become ripe at plan confirmation.

Marshaling and Surcharge Issues at Confirmation

In practice, DIP lenders rarely exercise remedies. They are typically repaid as the value of their collateral is realized throughout a chapter 11 case: through a sale of their collateral or pursuant to a consummated chapter 11 plan. Yet the principles of marshaling often influence value allocation under chapter 11 plans, and creditors' committees have argued that courts should deny confirmation of such plans in favor of a reverse-marshaling value allocation that benefits unsecured creditors.

Plan confirmation is the point in time where value allocation and value realization meet in chapter 11 and must be addressed by plan proponents. In large chapter 11 cases, it is common for debtors, their DIP lenders and their pre-petition secured creditors to seek confirmation of a plan that effectively marshals assets to the benefit of pre-petition secured creditors. Pre-petition unencumbered assets are allocated to repay the DIP lenders and other costs of administering the bankruptcy case, and the pre-petition encumbered assets are allocated to repay pre-petition secured creditors, thereby minimizing junior secured creditors' deficiency claims and maximizing their recoveries under the plan. DIP lenders have little incentive to push for any other value allocation. Given the cost and difficulty of "cramming up" pre-petition secured creditors, DIP lenders and pre-petition secured creditors find themselves in natural alignment on the issue of value allocation under chapter 11 plans.

In the face of a chapter 11 plan that allocates little, if any, value to unsecured claimants, creditors' committees may argue that value should effectively be reverse-marshaled to maximize the recovery of unsecured creditors — that the value of shared collateral should first be allocated to repayment of the DIP claims, leaving the value of pre-petition unencumbered assets for unsecured creditors. This allocation minimizes the recovery of pre-petition junior secured creditors: Their secured claims would be entitled to the value of the shared collateral, as reduced by the cost of repaying the DIP claims, and their deficiency

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6 *See In re Ctr. Wholesale Inc.*, 788 F.2d 541, 544 (9th Cir. 1986) ("We have found no authority for the proposition that a trustee or [DIP] may require a senior lienor to satisfy its claim out of a junior lienor's collateral."); *In re America's Hobby Ctr. Inc.*, 223 B.R. 275, 287 (Bankr. S.D.N.Y. 1998) ("The bank properly observes that an unsecured creditor may not utilize the doctrine of marshaling."). However, courts have allowed trustees (and creditors' committees standing in the shoes of trustees), as hypothetical lien creditors under § 544(a), to marshal assets, even when those trustees represent the interests only of unsecured creditors. *See In re High Strength Steel Inc.*, 269 B.R. 560, 574 (Bankr. D. Del. 2001); *America's Hobby Ctr.*, 223 B.R. at 287.

claims would then share any value left over ratably with unsecured creditors.

However, the law here favors secured creditors. The Bankruptcy Code ensures that unsecured creditors have priority over equity interests and subordinated claims under the absolute priority rule and receive under the plan no less than the amount they would have received if the debtors were liquidated under chapter 7 under the "best interests of creditors" test. The first hurdle is easily met. Holders of equity interests and subordinated claims fare no better than unsecured creditors when collateral is marshaled in favor of junior secured creditors.

Creditors' committees and unsecured creditors have argued that the second hurdle is the higher one. DIP lenders, the argument goes, would not choose of their own volition to marshal collateral in a liquidation. Instead, they would rationally resort to the collateral proceeds first available to them, which may result in the realization of shared collateral before the realization of pre-petition unencumbered assets. This argument relies on speculation and wrongfully discounts the discretion afforded a debtor in developing and presenting its liquidation analysis.[7] Moreover, this argument is susceptible to challenge from the DIP lenders, who can ally with pre-petition secured creditors and affirm to the court that they would marshal collateral in the event of an exercise of remedies.

Further, attempts by creditors' committees and other unsecured creditors to marshal assets in their favor are arguably veiled efforts to surcharge collateral under § 506(c). The Bankruptcy Code does not entitle unsecured creditors to the value of pre-petition unencumbered assets. As previously discussed, the general rule is that pre-petition unencumbered assets must bear the costs and expenses of administering the chapter 11 case. The only statutory exception to this rule is found in § 506(c), which provides debtors with a right to surcharge the reasonable, necessary costs and expenses of preserving or disposing of a creditor's collateral. Any argument that DIP lenders should look first to shared collateral for repayment may be construed as surcharge by any other name and would need to satisfy the appropriate standard under § 506(c). A surcharge waiver effectively takes this argument off the table as an impermissible collateral attack on the DIP order.

Creditors' committees may also argue that the plan overvalues secured claims by assuming that collateral would be marshaled, a violation of the corollary to the absolute-priority rule.[8] Put another way, the creditors' committee may argue that, in determining the secured status of a pre-petition secured claim under § 506(a), courts should assume that DIP lenders will elect not to marshal collateral. Although the Code leaves this point unaddressed, at least one court has refused to confirm a plan that treated a junior secured creditor as if its claim were unsecured by assuming the senior secured creditor would reverse-marshal shared collateral to the junior creditor's detriment.[9]

Case Study: *Chesapeake Energy*

These marshaling and related issues came to a head in *Chesapeake Energy Corp*.[10] In this case, the central question at the confirmation hearing on the debtors' reorganization plan was the proper allocation of value among creditors. The case illustrates how secured creditors can use marshaling and surcharge waivers to improve their recoveries in bankruptcy. It also provides an example of best-in-class drafting of a marshaling waiver that does not unintentionally harm the strategic position of secured creditors.

In *Chesapeake*, the marshaling waiver included in the court's final order approving the debtors' DIP financing made it clear that while the DIP lenders could choose to marshal, they could not be *forced* to marshal. The final order provided that "the DIP Agent *may* use commercially reasonable efforts to first apply proceeds of the DIP Collateral that is not Existing Collateral to satisfy the DIP Obligations before applying proceeds of DIP Collateral that is Existing Collateral to satisfy the DIP Obligations."[11] This nuance proved vital at the confirmation hearing.

In its objection to confirmation, the creditors' committee argued that the plan failed the best-interests test because the debtors' liquidation analysis assumed that DIP lenders would look first to unencumbered assets to satisfy their claims. The committee argued that this assumption was unreasonable and that a liquidation analysis that altered this assumption would show unsecured creditors recovering less under the plan than they would in a liquidation. However, the plan proponents successfully argued that the Chesapeake DIP order expressly preserved the DIP lenders' discretion to marshal assets, validating the assumptions in the debtors' liquidation analysis. Of particular value was the response of the DIP facility agent, who affirmed to the court that the DIP lenders could satisfy their obligations from the proceeds of pre-petition unencumbered collateral in the event of an exercise of remedies.[12]

Thus, the key takeaway from *Chesapeake* is that early in the case, secured creditors can protect against reverse-marshaling arguments from unsecured creditors by including a surcharge waiver and a flexible marshaling waiver in a DIP or cash-collateral order. Those concepts can enhance the strategic position of secured parties when allocating value under a reorganization plan while respecting the confines of the best-interests-of-creditors test. abi

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7 *See In re Charter Commc'ns*, 419 B.R. 221, 263 (Bankr. S.D.N.Y. 2009) (overruling challenge to debtor's liquidation analysis and reasoning that liquidation analysis "appears to have relied on reasonable assumptions").

8 The corollary to the absolute-priority rule provides that a creditor cannot be paid more than in full on account of its claims. *See In re Exide Techs.*, 303 B.R. 48, 61 (Bankr. D. Del. 2003).

9 *See In re Jenkins*, 99 B.R. 949, 951-52 (Bankr. W.D. Mo. 1988).

10 *In re Chesapeake Energy Corp.*, 622 B.R. 274 (Bankr. S.D. Tex. 2020).

11 *In re Chesapeake Energy Corp.*, D.I. 597 at 68 (emphasis added).

12 *See In re Chesapeake Energy Corp.*, D.I. 1976 at 7-8 (explaining that marshaling waiver did not require DIP lenders to satisfy their claims from shared collateral before existing collateral).