No. 15-1223

In the Supreme Court of the United States

SOUTHWEST SECURITIES, FSB, PETITIONER

v.

MILO H. SEGNER, JR., TRUSTEE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

SUPPLEMENTAL BRIEF FOR THE PETITIONER

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The government's brief makes two things clear: the government strongly disagrees with our position on the merits, and this case is the rare and perfect opportunity for resolving that disagreement.

The government leaves a number of important propositions undisputed. It does not dispute that this issue is extremely important and has generated pervasive confusion in the lower courts. It does not dispute that this is an ideal vehicle for resolving that significant conflict; it effectively acknowledges that the question is cleanly presented on a common fact-pattern, and there is no obstacle to review. It further does not dispute that this question rarely percolates up to the courts of appeals, despite its recurrence in lower courts.

The government quibbles about whether there is a direct conflict, but the government is wrong. The conflict is square, which is why the Fifth Circuit explicitly rejected the Seventh Circuit's "holding" on this legal question. Pet. App. 13a-14a (describing *In re Trim-X*, 695 F.2d 296 (7th Cir. 1982)). Indeed, the government effectively concedes the outcome would have been the opposite in the Seventh Circuit. And that circuit's conflicting analysis produces more than the "significant tension" the government admits: in the words of the Fifth Circuit itself, *Trim-X* adopted a "rule" that categorically "foreclosed" pre-abandonment maintenance expenses. And that is precisely how multiple courts (from a variety of jurisdictions) have understood *Trim-X*.

In the end, this case presents an important and recurring question of federal bankruptcy law. The issue arises in virtually every major bankruptcy, and the decision below deepens the hopeless confusion that will persist until this Court intervenes. The government may

disagree with petitioner on the merits, but that only underscores the substantial divide over this issue. This Court routinely grants review to resolve this kind of pervasive confusion in the bankruptcy context. The petition should be granted.

A. The Courts Are Squarely Divided Over The Question Presented

Contrary to the government's contention (Br. 15-21), there is no genuine dispute about the existence of a circuit conflict. The Fifth Circuit explained, in detail, that it was rejecting as "[un]persua[sive]" the Seventh Circuit's longstanding "holding" in *Trim-X*. Pet. App. 13a-16a. And it is equally clear that the Fifth Circuit's holding conflicts with the Eighth Circuit's decision in *Brookfield Prod. Credit Ass'n* v. *Barron*, 738 F.2d 951, 952-953 (8th Cir. 1984). Those decisions have provided workable guidance for decades, and there is no reason to think either circuit (much less *both* circuits) will revisit those decisions.

The government acknowledges "significant tension" at the circuit level, and never denies the pervasive confusion in the lower courts. For nearly three decades now, the surcharge issue has plagued bankruptcy cases, with judges confronting "more controversy [than] any field I know." *C.I.T. Corp.* v. *A&A Printing, Inc.*, 70 B.R. 878, 879-880 (M.D.N.C. 1987). That confusion is intolerable in a bankruptcy-context demanding uniformity. There is an obvious need for the Court's guidance on this important question.[1]

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[1] The government hints that Section 506(c)'s application is "case-specific" (Br. 15), but this dispute turns on the proper construction of the "benefit" clause in Section 506(c). That "question of law" has nothing to do with the specific facts of any given case. *Heidelberg*

1. The decision below is directly at odds with the Seventh Circuit's decision in *Trim-X*. The government takes issue with the Fifth Circuit's candid acknowledgement of a conflict, but the government is mistaken: *Trim-X* means what multiple courts have said it means, which is that a surcharge is categorically "foreclosed" for pre-abandonment maintenance expenses. Pet. App. 14a. The government concedes there is "significant tension" (Br. 19), but it should have recognized an outright conflict. See also, *e.g.*, *Heidelberg*, 200 B.R. at 143; *In re Wyckoff*, 52 B.R. 164, 166-168 (Bankr. W.D. Mich. 1985); *In re Proto-Specialties, Inc.*, 43 B.R. 81, 84 (Bankr. D. Ariz. 1984); U.S. Br. 19 n.4 (conceding lower-court conflict).

The government's error stems from skipping over the core of *Trim-X*'s analysis. The court explicitly held that "expenses incurred prior to the trustee's petition for abandonment were not for the [secured creditor's] benefit." 695 F.2d at 301. The fact that "the secured creditor eventually 'benefited' from these expenses in the sense that it received the assets unharmed" was insufficient. *Ibid.* As the court explained, "section '506(c) was not intended as a substitute for the recovery of administrative expenses that are appropriately the responsibility of the debtor's estate,'" and "placing the responsibility for these expenses on a secured creditor would discourage a trustee from taking reasonable steps to assess an estate's position." *Ibid.* It accordingly held, in conflict with the decision below, that pre-abandonment maintenance costs ("security costs," "utility charges," etc.) were excluded under Section 506(c).

Harris, Inc. v. *Grogan (In re Estate Design & Forms, Inc.)*, 200 B.R. 138, 142 (E.D. Mich. 1996).

In response, the government argues that *Trim-X* actually relied on "considerations of 'consent' and 'causation,' as bases for denying a surcharge." Br. 19. That misunderstands *Trim-X*. The court recognized pre-Code authority holding that "consent" and "causation" might *independently* justify a surcharge even without any "benefit" under Section 506(c). 695 F.2d at 301. These were *alternative* tests requiring separate showings; it is why *Trim-X* described the two tests in the *disjunctive*, and why multiple decisions (including those cited by *Trim-X*) describe the two tests as independent grounds for a surcharge. See, *e.g.*, *Trim-X*, 695 F.2d at 301 (surcharges allowed "when expenses of preservation are incurred primarily for the benefit of the secured creditor or where the creditor caused or consented to such expenses"); *First W. Sav. & Loan Ass'n*, v. *Anderson*, 252 F.2d 544, 547 (9th Cir. 1958).

Aside from "consent," *Trim-X* held that pre-abandonment expenses do not "benefit" creditors under Section 506(c): "[T]he bankruptcy court found that the expenses incurred prior to the time the trustee determined Trim-X had no equity in the assets were not for the benefit of [the secured creditor]. We agree with that conclusion to the extent it applies to expenses incurred before the trustee's commitment to abandon * * * ." 695 F.2d at 301. That "holding," of course, is the legal "rule" expressly rejected by the Fifth Circuit. Pet. App. 13a-14a; see *C.I.T.*, 70 B.R. at 880-881 ("[a]lthough the Seventh Circuit acknowledged that receiving one's collateral unharmed is a benefit of sorts, it is not the sort which opens up the creditor to Section 506(c) liability").

Contrary to the government's position, the fact that "*Trim-X* was decided 35 years ago" (Br. 19) supports *granting*, not denying, review. *Trim-X* has reliably served as controlling authority for decades; according to

Westlaw, it has been cited by 161 cases and 138 secondary sources. There is no reason to think the Seventh Circuit will suddenly reverse course. Moreover, the lack of "more recent court of appeals decisions" (U.S. Br. 19) again *favors* review. This issue is implicated in virtually every bankruptcy involving secured property, and bankruptcy judges have described the incredible confusion it has generated. That combination usually produces ample circuit-level authority; the lack of cases reaching appellate courts simply illustrates the practical impediments of litigating bankruptcy issues through the appellate process. This case is the rare exception to that rule.[2]

2. The government also downplays the conflict between the decision below and *Brookfield* (Br. 16-17), but the conflict is stark. As previously explained (Pet. 8-9; Reply 8), *Brookfield* held that debtors could not shift the costs of "preserving" encumbered property while that property remained in the debtor's control. 738 F.2d at 951. Although the debtors' costs were "both necessary and reasonable," the creditor did not "benefit" where the status quo (pre-foreclosure) is merely *maintained*; without an "*increase[]*" in value, there was no Section 506(c)

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[2] The government argues that certain lower courts relied on *Trim-X* "while authorizing surcharges of pre-abandonment expenses." Br. 19 n.4 (citing two cases). But *In re Nat'l Real Estate Ltd. P'ship-II*, 104 B.R. 968 (Bankr. E.D. Wis. 1989), authorized a surcharge during a period where the creditor *sought to lift the automatic stay and foreclose*. There is no indication the question here was raised or resolved, and the creditor *conceded* recovery for "'legitimate, properly documented property management expenses.'" 105 B.R. at 969-970, 972-973. Likewise, in *In re Piasecki*, No. 06-90643, 2007 WL 914337 (Bankr. C.D. Ill. Mar. 26, 2007), the creditor argued the expenses were "unnecessary and unreasonable," but apparently argued nothing about "benefit." And a motion seeking abandonment was pending during the relevant period. *Id.* at *2-*3.

"benefit." *Id.* at 952-953 (emphasis added); *id.* at 951 ("debtors were not entitled to the [pre-foreclosure] costs and expenses of preserving creditor's collateral"). That construction of Section 506(c)'s "benefit" clause is directly at odds with the Fifth Circuit's construction.

Contrary to the government's contention, *Brookfield* did not say that merely preserving the status quo—and avoiding waste or loss—confers a "benefit" under Section 506(c). Br. 17. *Brookfield* involved "necessary and reasonable" costs in *feeding turkeys and livestock*. It was obvious that *all* such costs prevent loss (turkeys and livestock require food). But the Eighth Circuit asked whether the collateral "*increased*" in value, not merely whether it *retained* value. 738 F.2d at 953. All feeding costs kept the collateral alive; in the government's words, the "property" obviously would have yielded less "value" if "the preservation expenses had not been incurred." Br. 17. But the court found that insufficient: those expenses were incurred under "the debtor's independent duty of reasonable care regarding the property in his possession," and the debtor could not shift those costs (pre-foreclosure) to the secured creditor. 738 F.2d at 952-953. A creditor may "benefit" from "*increased*" value, but not where the status quo is merely preserved during the debtor's control. *Id.* at 953 ("'§ 506(c) was not intended as a substitute for the recovery of administrative expenses that are appropriately the responsibility of the debtor's estate.'"). That approach aligns directly with *Trim-X* but conflicts with the decision below.[3]

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[3] *Brookfield* relied specifically on *Dozoryst* v. *First Fin. Sav. & Loan Ass'n of Downers Grove*, 21 B.R. 392 (N.D. Ill. 1982), which itself required "added dollar value" to prove a Section 506(c) "benefit" to avoid undermining the integrity of secured interests: "This view of the statute is called for not only by its clear language but by

The government has no explanation for what else this language could possibly mean. The court *twice* repeated the rule that Section 506(c) is not an excuse for passing off the debtor's (pre-foreclosure) costs of preserving estate assets, and it ultimately faulted the debtors for failing to prove an *increase* in value while assets remained in the estate. Under the government's theory, by contrast, none of that discussion was necessary: there is no reason to demand a showing of "increased" value because *maintaining* value is enough. Br. 17. Yet *Brookfield* took an entirely different approach. It emphasized the debtor's independent duty to maintain the status quo, and, unlike the Fifth Circuit, refused to find any "benefit" where the initial baseline was merely preserved while the debtor retained the property. That reading of Section 506(c) is irreconcilable with the government's position. See *In re Harbour E. Dev., Ltd.*, No. 10-20733, 2011 WL 6097063, at *4 (Bankr. S.D. Fla. Dec. 6, 2011).

3. This 2-1 conflict is clear and intractable. Under *Trim-X* and *Brookfield*, if trustees elect to retain encumbered property, they have to use estate funds to pay estate costs of preserving that property and avoiding waste. There is no Section 506(c) "benefit" from receiving assets unharmed. This conflict now leaves "expenses incurred prior to the trustee's petition for abandonment" (*Trim-X*, 695 F.2d at 301) eligible for relief (or not) de-

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the special position of the secured creditor under the Bankruptcy Code. Because there can properly be no impairment of the security, *added dollar value* must be injected by the trustee's actions before any like amount may be charged against the fund. Were that not the case, *the value of the secured creditor's position could be impermissibly diminished by the trustee's exercise of dominion over the collateral*." 21 B.R. at 394 n.3 (emphases added).

pending on in which State the bankruptcy happens to arise.[4]

B. The Question Presented Is Important And Recurring

The proper construction of Section 506(c) is a recurring question of great importance. The government's response only confirms the need for further review.

First, it says that courts "routinely" permit surcharges in this situation "without triggering any sweeping expansion" of Section 506(c). Br. 21. But that *is* the *sweeping expansion of Section 506(c)*. That section is the *exception* to the rule (Pet. App. 6a); it is designed to apply in "sharply limited" circumstances. *In re Visual Indus., Inc.*, 57 F.3d 321, 325 (3d Cir. 1995); *In re Adam Aircraft Indus., Inc.*, 527 B.R. 709, 715 (D. Colo. 2014) ("'Ordinarily, the costs and expenses detailed in Section 506(c) are paid from the unencumbered assets of a bankruptcy estate rather than from secured collateral.'"). Yet the government's theory would hold secured creditors liable in virtually *every* bankruptcy—whenever a trustee retains property for any reason and incurs maintenance expense. Such surcharges are *not* "routine[]" in multiple jurisdictions, and there is an obvious reason the government's position has been rejected in those courts.

Second, the government says the question presented does not "'arise[] virtually every time a trustee retains []encumbered property" because parties "often" "negoti-

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[4] *In re Parque Forestal, Inc.*, 949 F.2d 504 (1st Cir. 1991), is distinguishable (contra U.S. Br. 20): the secured claim indisputably "exceeded the value of its security interest * * * by several million dollars," extinguishing the estate's interest, and expenses were paid by third parties seeking reimbursement from the creditor; no one contended the estate had any interest in the property. 949 F.2d at 506, 512.

ate" away their Section 506(c) rights. Br. 22. But this proves *our* point: the *question* assuredly does arise even if parties *settle* the issue; otherwise there would be *nothing to settle*. And parties cannot intelligently negotiate their rights without understanding what those rights actually are. The profound confusion today infects those negotiations—secured creditors are either giving up too much or trustees are demanding too little.

This issue is exceedingly important to the proper administration of the Code. It dictates whether secured creditors can be forced to subsidize the trustee's efforts to seek value for the estate, and it undermines the integrity of secured interests (which are supposed to pass through bankruptcy unaffected). This is the rare case that survived the appellate process despite the usual economics of bankruptcy litigation. Pet. 16. Review is warranted.

C. The Government's Merits Arguments Underscore The Need For Immediate Review

The government devotes much of its brief to arguing the merits. While petitioner welcomes that debate at plenary review, the most relevant point here is the sharp contrast between the government's position and the authority above.

But a brief response:

1. The government's textual argument is meritless. Contrary to the government's contention (Br. 9-10), everyone understands the dictionary definition of "benefit." But it is impossible to determine "advantage" or "profit" without *first determining the relevant statutory baseline*. The Code mandates that trustees retaining estate property must preserve that property and avoid waste. Pet.10-11. Avoiding harm is not a "benefit" under any ordinary use of that term. In common parlance, for example, few say employees confer a "benefit" on a corpo-

ration by not stealing corporate assets, or a manufacturer confers a "benefit" on a community by not releasing toxic waste. Baseline duties and obligations matter. Discharging a preexisting statutory obligation merely avoids harm; it does not confer a "benefit."

The government's construction also effectively reads the critical statutory phrase ("to the extent of any benefit to the holder of such claim") straight out of the Code. According to the government, "preserving" property itself confers a "benefit" on secured creditors. Br. 11. But Section 506(c) *presumes* collateral will be "preserved"; it imposes a *separate* requirement that such preservation "benefits" the secured creditor. If that "benefit" is satisfied by preservation alone, the distinct "benefit" clause has no independent meaning.

Under petitioner's reading, by contrast, the trustee is obligated to maintain the status quo; maintenance expenses simply discharge that background duty. That means if the trustee *improves* the property, the expense might qualify (because there is a distinct "benefit" to the holder of the secured claim); or if the trustee maintains the property *after* abandonment, then the expense might qualify (because at that point the expense is properly the creditor's responsibility, not the trustee's). Contrary to the government's contention (Br. 12), this does not "come close to negating" Section 506(c); it merely cabins this "extraordinary" exception (Pet. App. 6a) to its proper scope.

2. The government's equity argument (Br. 14-15) is entirely inequitable. There is nothing unfair about asking the estate to cover estate costs while the estate insists on retaining ownership and control of the property. But there is unfairness in a trustee refusing to abandon property and then charging secured creditors for the trustee's privilege of keeping secured assets. That deci-

sion eliminates the opportunity for secured creditors to immediately use or dispose of property on their own terms. *Heidelberg*, 200 B.R. at 142. It instead permits trustees to gamble with secured interests and then ask secured creditors to pay the costs when the gamble fails. *C.I.T.*, 70 B.R. at 882. This is inconsistent with basic notions of fairness: A party should not be forced to shoulder the expenses of ownership without owning anything.

3. The government's historical argument is incorrect. The government argues that Section 506(c) codified preexisting law and "[p]re-Code surcharge practice" supports the government. Br. 12-14. But pre-Code practice was "'somewhat inconsistent'" (Pet. App. 9a n.7) and reflects the same confusion that still exists today. Indeed, *Trim-X* relies on two of the same pre-Code cases the government cites—and reached the *opposite* conclusion regarding Section 506(c). 695 F.2d at 299 (citing *Textile Banking Co.* v. *Widener*, 265 F.2d 446 (4th Cir. 1959), and *First Western*, *supra*). If the government wishes to depart from the traditional rule that estate funds pay for estate costs, it has to do better than this.

Respectfully submitted.

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MAY 2017