

Broadway Realty Ruling Highlights Narrow Scope of Collateral Surcharges

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Another bankruptcy court decision shows the skepticism of courts to Chapter 11 debtors' arguments that they can surcharge a creditor's collateral to pay extensive administrative expenses, such as professionals' fees. A decision from Judge Jones in the Southern District of New York emphasizes again, how bankruptcy courts are hesitant to allow such broad surcharge claims under section 506(c) of the Bankruptcy Code. *See In re Broadway Realty I Co., LLC*, No. 25-11050 (DSJ), 2025 WL 1803089, at *1 (Bankr. S.D.N.Y. June 29, 2025). The decision also dealt with other issues, principally adequate protection in the form of "shared" equity cushions between multiple affiliated debtors. But in addressing 506(c), Judge Jones took issue with a sweeping effort to justify a surcharge of "millions of dollars of professional fees and other administrative expenses" on the theory that the Chapter 11 case generally benefited the secured lender.

The debtors, 82 entities which owned a number of multifamily residential rental buildings, filed bankruptcy to block foreclosure actions proceeding in state court. The secured lender contested the debtors' cash collateral motion, arguing that the proposed expenses depleted its cash collateral without adequate protection. The debtors responded, in part, by arguing that the expenses should not require an adequate protection analysis (or themselves constituted adequate protection) because they benefited the lender's collateral and therefore could be surcharged under section 506(c).

Judge Jones was not convinced. After finding that the lender was not adequately protected by "shared" equity cushions between the debtors, he addressed the surcharge argument. Section 506(c) surcharges, he found, might sometimes be relevant to the question whether a lender is adequately protected for a debtor's expenditures, but here, the debtors argument that nearly all of its expenditures, including millions of dollars in professionals' fees, "adequately protected" the lender was overbroad. What made the surcharge attempt particularly egregious in *Broadway Realty* was the fact that the debtors sought to apply the surcharge "prospectively," that is, before the administrative expenses were incurred, and that the debtors argued that their ability to pay such expenses then surcharge the collateral, supported a claim that the creditor was adequately protected for the use of its cash collateral. Section 506(c), Judge Jones found, is not intended to serve this purpose, but was intended to apply to expenses already incurred, and was not intended to support an argument of adequate protection.

There are two principal takeaways for debtors entering Chapter 11. First, most bankruptcy courts remain hostile to the argument that a secured creditor's hypothetical benefit from the case can ever justify charging their collateral for the expenses of the case. It's not simply a matter of crafting a convincing evidentiary showing that the creditor will do better through a Chapter 11 plan or 363 sale, instead, section 506(c) is simply not intended to govern such "broad" benefits, only to justify narrow and specific surcharges for necessary collateral-based expenses.

Second, because section 506(c) is retrospective, it can only be invoked after the expenses have been incurred. This, of course, places the risk on the debtor incurring the expense, that it will be seen as a justifying surcharge. It also places the premium on negotiation with the creditor in advance of incurring the expense to mitigate that risk. In reality, if broad

administrative expense support is to be sought, the debtor should attempt to do so through a restructuring support agreement or similar arrangement prior to filing the case.