



An Oversecured Creditor's Post-Petition Attorneys' Fees, Governed by State Law
or Federal Law's 11 U.S.C. 506(b)

Charles Lazo, J.D. Candidate 2016

Cite as: *An Oversecured Creditor's Post-Petition Attorneys' Fees, Governed by State Law or Federal Law's 11 U.S.C. 506(b)*, 7 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 14 (2015).

Introduction

In bankruptcy, an oversecured creditor¹ is generally entitled to post-petition interest on their underlying claims, and post-petition reasonable fees, costs, or charges provided for under a contract or state statute.² Although an oversecured creditor might be entitled to attorneys' fees under a contract provision or a state statute, bankruptcy courts will review such fees for reasonableness. However, the Bankruptcy Code does not provide what laws govern on the issue of whether fees are reasonable. Currently, there is a three-way split among courts: (1) the majority of courts rule that federal law preempts state law as to the enforceability and reasonableness of oversecured claims; (2) some courts rule that state law governs enforceability and federal law governs reasonableness; (3) some outlier courts ruled that state law governs, which have been overruled and is no longer good law in their jurisdictions.

¹ An oversecured creditor is a creditor who holds a lien on a property in which the debtor's interest in that property has a greater value than the amount of the lien. *See* 11 U.S.C. § 506(b) (2012).

² *Id.*

Practically, even if a court determines that a fee is not reasonable, the oversecured creditor may still recover a proportion of its "unreasonable" fees under section 502.³ The majority of courts will allow oversecured creditors to recover part of the unreasonable portion of the fees as an unsecured claim. However, some circuit courts have not specifically reach this issue.⁴

This Article will examine the split among courts regarding whether state or federal law governs post-petition attorneys' fees. Part I generally examines section 506(b) of the Bankruptcy Code. Part II discusses the split on whether state or federal law govern post-petition attorneys' fees and how the majority and minority of courts have ruled on this issue, analyzing the reasoning and arguments behind those courts' decisions. Part III discusses how an oversecured creditor may be entitled to an unsecured claim for the "unreasonable" portion of its attorneys' fees under section 502 of the Bankruptcy Code. Finally, Part IV identifies the implications for an oversecured creditor's attorneys in bankruptcy proceedings.

Overview of Section 506(b) of the Bankruptcy Code

Generally, under section 506(b), an oversecured creditor is entitled to post-petition interest on its claim, and "any [post-petition] reasonable fees, costs, or charges provided for under the agreement or state statute under which such claim arose."⁵ Under section 506(b), an oversecured creditor's post-petition⁶ fees, costs, or charges are allowed if (1) the oversecured creditor has an allowed oversecured claim, (2) the post-petition fees, costs, or charges are

³ However, if the plan provides that the unsecured creditor is entitled to receive all of its fees under the contract, the distinction between reasonable and unreasonable fees is eliminated. Thus, the creditor will be entitled to one hundred percent of the fees, not just a portion.

⁴ See *In re* 804 Cong., L.L.C., 756 F.3d 368, 380 (5th Cir. 2014) (questioning whether oversecured creditor "have included included in their briefing in this court regarding treatment of their claims, or parts of their claims, as unsecured claims under § 502 were raised in the bankruptcy court").

⁵ 11 U.S.C. § 506(b).

⁶ See *In re* Nunez, 317 B.R. 666, 670 (Bankr. E.D. Pa. 2004) ("[s]ection 506(b) applies only to post-petition interest, fees and costs sought as part of a secured claim.").

provided for under an agreement or a state statute under which the creditor's claim arose, and (3) the post-petition fees, costs or charges are "reasonable."⁷ However, section 506(b) does not indicate whether state or federal law applies in determining whether such fees are "reasonable." This lack of statutory guidance has, thus, resulted in a court split regarding which law governs the court's determination of whether an oversecured creditor's attorneys' fees are reasonable.

The Three-Way Spilt in Determining Whether to Allow an Oversecured Creditor's Attorneys' Fees

As noted above, there is a three-way split among courts as to whether state or federal law applies in determining whether attorney fees are "reasonable". The majority of courts rule that federal law preempts state law as to the enforceability and reasonableness of oversecured claims. Most of the minority courts rule that state law governs enforceability and federal law governs reasonableness, but some outlier courts ruled that state law governs.

The majority of courts have reasoned that federal law preempts state law based on section 506(b)'s plain language and legislative history. The minority of courts, however, have held that state law governs on whether the agreement is enforceable, and then federal law governs on whether the post-petition fees are reasonable based their reason on that the bankruptcy courts, courts of equity, should enforce a creditor's legal rights whether it is based as a contractual right or property right. Further, there are outlier courts that have simply ruled that state law governs reasonableness of an oversecured creditor's attorneys' fees.

a. Majority Rule – Federal Law Governs

The majority of courts held that federal law, not state law, governs whether post-petition attorney fees are reasonable under section 506(b). In so holding, the majority of courts stress that

⁷ See 11 U.S.C. § 506(b).

there is no reference to state law in section 506(b)'s plain language.⁸ Section 506(b), which directs courts to "allow[s] any reasonable fees, costs, or charges provided for under the agreement under which such claim arose,"⁹ does not direct courts to allow oversecured claims in accordance with state law. Thus, state law should not govern attorneys' fees. Further, the majority of courts reasoned that other sections of the Bankruptcy Code indicate "that Congress, when it desired to do so, knew how to restrict the scope of applicable law to 'state law' and did so with some frequency."¹⁰ Therefore, these courts reasoned that the absence of such language in section 506(b) indicates that federal law should govern whether an oversecured creditor's attorneys' fees are reasonable under section 506(b).¹¹

Moreover, the majority of courts opine that section 506(b)'s legislative history indicates that federal law preempts state law in governing the reasonableness of post-petition fee provisions.¹² The courts noted that while the House of Representatives and the Senate each passed a different draft of the provision,¹³ ultimately, the Senate draft was enacted. On one hand, the House draft provided that "there shall be allowed to the holder of such claim, to the extent collectible under applicable law . . . any reasonable fees,"¹⁴ favoring application of state law. On

⁸ See *In re Schriock Constr.*, 104 F.3d 200, 202 ("Section 506(b) itself does not direct us to state law."); *In re Ctr.*, 282 B.R. 561, 566 (Bankr. D.N.H. 2002) ("Section 506(b) makes no reference to state law.").

⁹ 11 U.S.C. § 506(b).

¹⁰ *Patterson v. Shumate*, 504 U.S. 753 (1992); See also 11 U.S.C. § 109(c)(2) ("An entity may be a debtor under chapter 9 of this title if and only if such entity" . . . is authorized *by state law*) (emphasis added); 11 U.S.C. § 523 (stating debt for arising from a separation agreement of divorce decree made in accordance *with state or territorial law* is not dischargeable) (emphasis added); 11 U.S.C. § 903(1) ("[A] *State law* prescribing a method of composition of indebtedness of such municipality may not bind" non-consenting creditors).

¹¹ *In re Ctr.*, 282 B.R. at 566 (indicating absence of state law reference is evidence of Congress' intention of state law preemption). Thus, when the text of a Bankruptcy Code section is not explicitly limited to state law, the statute should be plainly read and be enforced according to its terms

¹² *Joseph F. Sanson Inv. Co. v. 268 Ltd. (In re 268, Ltd.)*, 789 F.2d 674, 676 (9th Cir. 1986) ("Section 506(b)'s legislative history also favors reading the statute as preempting the state law governing the reasonableness of fee provisions.").

¹³ *In re Schriock Constr.*, 104 F.3d at 202.

¹⁴ H.R. 8200, 95 Cong., 1st Sess. § 506(b) (1977).

the other hand, the Senate draft did not include the language “under applicable law,”¹⁵ favoring application of federal law. Therefore, majority of courts reasoned that by enacting the Senate draft, “Congress declined to require that the bankruptcy courts consult the governing state law to determine the reasonableness of fees claimed under [section] 506.”¹⁶ Further, these courts have noted that the floor managers of the bill, Senator De Concini and Representative Edwards, reported to Congress that the House version of the bill was rejected and that if a security agreement provided for attorneys’ fees, it will be enforced under the Bankruptcy Code, notwithstanding contrary law.¹⁷ Thus, with the guidance of section 506(b)’s plain language and legislative history, the majority of courts concluded that federal law should apply to determine the reasonableness of post-petition fees.

b. Minority Rule – State Law Governs

The minority courts have held that state law should govern an oversecured creditor’s post-petition attorneys’ fees’ validity and enforceability, but federal law governs reasonableness. There is a split on whether the validity of post-petition fees arises from contractual law or property law. Nevertheless, after the validity of fees is established, the minority of courts state that the fees should undergo a section 506(b) reasonableness analysis.¹⁸

As a preliminary matter, the minority of courts stated that bankruptcy courts are courts of equity.¹⁹ Thus, the minority of courts asserted that bankruptcy courts cannot “modify or ignore the terms of the legal obligation.”²⁰ The minority courts reasoned that a party should be able to stand upon the terms of a valid contract in a court of equity just as that party would in a court of

¹⁵ S. 2266, 95 Cong., 2d Sess. § 506(b) (1978).

¹⁶ *In re 268, Ltd.*, 789 F.2d at 678.

¹⁷ *In re Schriock Constr.*, 104 F.3d at 202.

¹⁸ *See In re Sholos*, 11 B.R. 782, 784 (Bankr. W.D. Pa. 1981).

¹⁹ *Manufacturers' Fin. Co. v. McKey*, 294 U.S. 442, 448 (1935).

²⁰ *Id.*

law.²¹ However, if the party is looking for equitable relief, then the bankruptcy court should be allowed to use its “extraordinary powers” to grant that party pure equitable relief.²² In cases where oversecured creditors are attempting to recover attorneys’ fees, however, creditors are seeking to enforce a legal right, not equitable relief.

State law governs the validity and enforceability of state law. On one hand, some courts have reasoned that these legal rights arise from underlying contractual rights. These courts asserted that the validity and construction of cost recovery contract clauses must be assessed under state law.²³ These courts further reasoned that “[local law] which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as fully as if they had been expressly referred to or incorporated in its terms.”²⁴ Thus, the underlying agreement “embraces alike those laws which affect its construction and those which affect its enforcement or discharge.”²⁵

Consequently, any contractual indebtedness is “not subject to statutory limitations on reimbursement for expenses of administering the estate.”²⁶ If any contract provides for attorneys’ fees, state law should govern its validity.²⁷

On the other hand, other courts held that the validity of fees might arise as a matter of property rights.²⁸ Under section 541(b) of the Bankruptcy Code, the debtor’s bankruptcy estate

²¹ *Id.* (“A party may stand upon the terms of a valid contract in a court of equity as he may in a court of law.”).

²² *Id.*

²³ *In re United Merchants & Mfrs., Inc.*, 674 F.2d 134, 139 (2d Cir. 1982) (“The Court recognized that ‘(t)he validity and construction of the (contract clause providing for recovery of costs) must ... be judged according to (state) law...’” (quoting *In re Cont'l Vending Mach. Corp.*, 543 F.2d 986, 993 (2d Cir. 1976))).

²⁴ *Farmers' & Merchants' Bank of Monroe, N.C. v. Fed. Reserve Bank of Richmond, Va.*, 262 U.S. 649, 660 (1923). *See Sec. Mortgage Co. v. Powers*, 278 U.S. 149, 153, 49 S. Ct. 84, 85, 73 L. Ed. 236 (1928) (“The validity of the lien claimed by the mortgage company for attorney's fees must be [determined by state law] for the contract was there made and was secured by real estate there situate.”).

²⁵ *Farmers' & Merchants' Bank of Monroe, N.C. v. Fed. Reserve Bank of Richmond, Va.*, 262 U.S. at 660.

²⁶ *In re United Merchants & Mfrs., Inc.*, 674 F.2d at 139.

²⁷ *In re Salisbury*, 58 B.R. 635, 640 (Bankr. D. Conn. 1985) (determining attorneys’ fees under state law’s concept of reasonableness).

includes “all legal and equitable interests of the debtor in property as of the commencement of the case.”²⁹ When a borrower executes a deed of trust, the lender receives an equitable title interest in the underlying property and, thus, an equitable interest in the borrower’s property subject to state law.³⁰ After, the federal bankruptcy court should ensure that the mortgagee is afforded the same protection that mortgagee would have under state law if no bankruptcy had ensued, specifically the recovery of attorneys’ fee.

When it comes to the section 506(b)’s analysis, these courts all state that the reasonableness of such attorneys’ fees are matters of federal law.³¹ The courts do not make any analysis, but cite to treatises and or past cases that plainly state federal law applies.³²

Finally, there are the outlier minority courts that simply state that state law should govern an oversecured creditor’s attorneys’ fees.³³ However, these cases are usually from the 1980’s and are undermined by its respective higher courts.³⁴

Unsecured Claims for the “Unreasonable” Portion of Attorneys’ Fees.

Generally, if a court determines that some or all of the attorneys’ fees are not "reasonable" under section 506(b), the oversecured creditor may still be entitled to an unsecured claim for the “unreasonable” portion of the attorneys’ post-petition fees, costs, or charges under

²⁸ *Butner v. United States*, 440 U.S. 48 (1979) (“Property interests are created and defined by state law.”); *In re Chateaugay Corp.*, 150 B.R. at 538 (“As a general rule, the underlying property rights of parties in a bankruptcy case are determined in accordance with applicable state law.”); *In re Virginia Foundry Co.*, 9 B.R. 493, 495 (W.D. Va. 1981) (“In bankruptcy proceedings, the extent and nature of property rights are determined in accordance with state rather than federal common law.”)

²⁹ 11 U.S.C. § 541(a) (2014).

³⁰ *See Williams v. Nationstar Mortgage, LLC*, 349 S.W.3d 90, 94 (Tex. App. 2011) (“When a borrower executes a deed of trust, ... the borrower ... retained the property’s legal title, and the lender ... held two equitable title interests in the property, one for each deed of trust.”).

³¹ *In re Schrader Body, Inc.*, 315 F. Supp. 1349, 1351 (W.D. Pa. 1970) (“[T]he reasonableness and enforceability in bankruptcy are matters of federal law.”). *See In re Alpine Grp., Inc.*, 151 B.R. 931, 935 (B.A.P. 9th Cir. 1993); *In re Sholos*, 11 B.R. at 785.

³² *In re Schrader Body, Inc.*, 315 F. Supp. at 1351 (citing to Collier on Bankruptcy and case law); *In re Alpine Grp., Inc.*, 151 B.R. at 935 (citing to past case law).

³³ *In re Triangle Equip. Co., Inc.*, 26 B.R. 175, 177 (W.D. Va. 1982).

³⁴ *See In re Saunders*, 130 B.R. 208, 212 (Bankr. W.D. Va. 1991).

section 502.³⁵ As a practical result, most if not all courts³⁶ hold that section 502 allows for all claims unless it meets any of the section 502(b) exceptions.³⁷

For example, in *Welzel v. Advocate Realty Inv. LLC (In re Welzel)*³⁸, the Eleventh Circuit held that a secured creditor is able to recover a secured claim for a reasonable amount, and an unsecured claim for the unreasonable amount.³⁹ The Eleventh Circuit noted that while section 506 dealt with the allowance of oversecured claims, the statute does not state that that fees deemed unreasonable are to be disallowed.⁴⁰ Rather, section 502 deals with the allowance of a claim.⁴¹ Section 502 indicates that a claim filed under section 501 the Bankruptcy Code is deemed allowed “unless a party of interest . . . objects.”⁴² If an objection arises, section 502 “shall allow that claim” unless the claim meets one of the exceptions enumerated in section 502(b).⁴³ Further, while section 502 does not differentiate between unreasonable and reasonable claims, section 506(b) focuses on the reasonableness of an oversecured claim.⁴⁴ Therefore, the Eleventh Circuit reasoned that the plain meaning of section 502 and 506 signified that “[section] 506(b) is meant not to displace the general instructions laid down in [section] 502, but to be read together with [section] 502 in a complementary manner.”⁴⁵ Section 506’s title, “Determination of

³⁵ See 11 U.S.C. § 502.

³⁶ However, some courts have not addressed this issue yet. *See In re 804 Cong., L.L.C.*, 756 F.3d at 380. And some courts do not agree. *See In re 900 Corp.*, 327 B.R. 585 (Bankr. N.D. Tex. 2005).

³⁷ *See Welzel v. Advocate Realty Inv. LLC (In re Welzel)*, 275 F.3d 1308, 1320 (11th Cir. 2001).

³⁸ 275 F.3d at 1308.

³⁹ *See id.* at 1320 (“[A] claim for fees should be bifurcated between secured and unsecured claims based on the amount of fees deemed reasonable.”); *See also UPS Capital Bus. Credit v. Gencarelli (In re Gencarelli)*, 501 F.3d 1, 5 (1st Cir. 2007) (holding that § 502 “allows the ultimate test for allowability, and any claim satisfying that test is . . . collectible as an unsecured claim”).

⁴⁰ *See In re Welzel*, 275 F.3d at 1317.

⁴¹ *See* 11 U.S.C. § 502.

⁴² 11 U.S.C. § 502(a).

⁴³ *Id.* § 502(b).

⁴⁴ *Id.* § 506(b).

⁴⁵ *In re Welzel*, 275 F.3d at 1317.

secured status,” indicates that it is narrowly focuses on whether a claim is secured, oversecured, or not secured as opposed to whether a claim is initially allowed under section 502.⁴⁶

In contrast, there are a minority of courts that would not allow the recovery of the unreasonable portion of post-petition fees, cost, or chargers as an unsecured claim. For instance, in *In re 900 Corp.*⁴⁷, the bankruptcy court held that an unsecured claim for post-petition attorneys’ fees cannot be recovered, even where provided by an agreement,⁴⁸ and reduced an oversecured creditor’s attorney fees from \$191,435.50, as provided for under an agreement, to \$140,382.28, disallowing the rest.⁴⁹ The bankruptcy court reasoned that the oversecured creditor’s attorneys did not exercise careful billing judgment, and granting the attorney fees as an unsecured claim would run contrary to section 506(b)’s purpose, which is to “protect estate assets from excessive fees by oversecured creditors' attorneys exhibiting excessive caution, overzealous advocacy and hyperactive legal efforts.”⁵⁰ The bankruptcy further noted that the counsel providing professional services bears the burden of exercising particularly careful billing judgment.⁵¹

Implications for Oversecured Creditors

Oversecured creditors are generally entitled to post-petition reasonable fees, costs, or charges provided for under a contract or state statute. However, oversecured creditors holding an oversecured claim may be limited to a reasonable portion of its post-petition reasonable fees, costs, or charges. This can lead to the oversecured creditor recovering fewer fees than it would have had state law governed.

⁴⁶ *Id.*

⁴⁷ *In re 900 Corp.*, 327 B.R. 585 (Bankr. N.D. Tex. 2005).

⁴⁸ *Id.* at 600.

⁴⁹ *Id.*

⁵⁰ *Id.* at 599.

⁵¹ *Id.*

The overwhelming majority of courts held that the reasonableness determination is determined under federal law. Some minority courts expand on this and require that any post-petition reasonable fees, costs, or charges be, first, enforceable under state law. However, it seems likely that the majority of courts that held federal law preempts state law presume that post-petition reasonable fees, costs, or charges are nevertheless enforceable under state law. Oversecured creditors should be prepared to demonstrate that any post-petition attorneys' fees are reasonable, which requires documentation or testimony evidencing the fees' reasonableness,⁵² or consult with local rules regarding collecting post-petition attorneys' fees. Accordingly, under the majority rule, since federal law might vary significantly from state law, an oversecured creditor might not be able entitled to a secured claim for its "unreasonable" attorneys' fees, even though such fees would be recoverable under state law. However, an oversecured creditor might still be able to recover at least some of the "unreasonable" portion of its attorneys' fees. Specifically, even under the majority rule⁵³, an oversecured creditor may be entitled to an unsecured claim for the "unreasonable" portion of its attorneys' fees under section 502.⁵⁴

Conclusion

Currently, there is a three-way split among courts in determining what law governs whether an oversecured creditor is entitled to its claim, under section 506(b), for post-petition fees, costs, or charges provided for under a contract or state statute. The majority of courts hold that federal law preempts state law as to the enforceability and reasonableness of these claims.

⁵² See *In re 804 Congress, L.L.C.* at 372 (suggesting proper applications for attorneys' fees and supporting documentation and testimony will evidence reasonableness under section 506(b)).

⁵³ *Id.* at 378 ("Several courts have concluded that § 506(b) deals with the priority of secured claims, not allowance of claims.⁴⁴ These same courts have indicated that certain claims for amounts found not to be reasonable under § 506(b) may be recoverable under § 502.").

⁵⁴ See 11 U.S.C. 502 (2012). Section 502 indicates that a claim filed under section 501 the Bankruptcy Code is deemed allowed unless a party of interest objects. If an objection arises, section 502 shall allow that claim unless the claim meets one of the exceptions enumerated in section 502(b).

The minority courts are split: most minority courts hold that state law governs enforceability and federal law governs reasonableness; some outlier minority courts ruled that state law governs both the enforceability and reasonableness. However, these outlier cases have been overruled and are no longer good law in their jurisdictions. Finally, some courts will still allow unreasonable post-petition attorney's fees as an unsecured claim under section 502.