

Legal Fees in Bankruptcy

By William L. Thuston Jr.

Numerous jurisdictions have held that the unsecured creditors cannot recover legal fees in a bankruptcy proceeding. See *In re Electric Machinery Enterprises, Inc.*, 371 B.R. 549, 550 (Bankr. M.D. Fla. 2007); *In re Global Indus. Techs., Inc.*, 327 B.R. 230, 239 (Bankr. W.D. Pa. 2005); *In re Hedged-Investments Assocs., Inc.*, 293 B.R. 523, 525-26 (D. Col. 2003); *In re Southeast Banking Corp.*, 188 B.R. 452, 462 (Bankr. S.D. Fla. 1995); *In re Woodmere Investors Ltd. P'ship*, 178 B.R. 346, 356 (Bankr. S.D.N.Y. 1995). These courts have set forth four basic arguments to support their position that legal fees are not allowable: 1) the Bankruptcy Code implicitly denies fees to unsecured creditors by specifically stating that over-secured creditors may collect reasonable fees; 2) the U.S. Supreme Court's decision in *United Savings Ass'n v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365 (1988) specifically disallowed post-petition interest to under-secured creditors leads to a finding that legal fees are also precluded; 3) Bankruptcy Code §502(b) requires a court to calculate a claim as of the petition date, thereby excluding fees that accrue post-petition; and 4) it would be inequitable for unsecured creditors to recover fees because it would reduce the money available to other creditors who aren't able to claim fees.¹

Other courts have held that the validity of a creditor's claim for legal fees depends on state law and not whether the claim is secured. See e.g. *In re Qmect, Inc.* 368 B.R. 882, 883 (Bankr. N.D. Cal. 2007); *Spence v. Joseph S. Knecht & Co.*, 194 Fed. Appx. 102 (4th Cir. 2006) (unpublished); *Spence v. Joseph S. Knecht & Co.*, 2005 U.S. Dist. LEXIS 43298 (D.S.C. 2005); *In re New Power Co.*, 313 B.R. 496, 510 (Bankr. N.D. Ga. 2004); *In re Welzel*, 275 F.3d 1308, 1319 (11th Cir. 2001); *In re Byrd*, 192 B.R. 917, 919 (Bankr. E.D. Tenn. 1996); *Liberty Nat. Bank & Trust Co. of Louisville v. George*, 70 B.R. 312, 317 (W.D. Ky. 1987); *In re United Merchants & Mfrs., Inc.*, 674 F.2d 134, 138 (2d Cir. 1982).

Additionally, these courts have pointed out that Congress could have disallowed unsecured creditors' claims for post-petition fees in Bankruptcy Code section 502(b) if it had wanted to do so. Notably, section 502(b) does not include legal fees among its nine enumerated exceptions to the general allowance of claims. Finally, these courts have noted that it would be inequitable to allow solvent debtors to retain funds without paying attorneys' fees which unsecured creditors would be entitled to outside of bankruptcy.²

The U.S. Supreme Court had an opportunity to settle this issue in *Travelers Cas. & Sur. Co. of Am. V. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007), when it expressly acknowledged the split decisions on this issue. However, the Court refused to resolve the issue because it had not been properly raised in the lower courts. The Court did, however, overturn the rule set out in *Fobian v. Western Farm Credit Bank*, 951 F.2d 1149 (9th Cir. 1991), which had prevented creditors from recovering fees associated with bankruptcy remedies but allowed the recovery of fees in connection with enforcing state law claims. Additionally, the Court noted that under Bankruptcy Code section 502 there is a general presumption claims allowed under state law will also be allowed in bankruptcy unless expressly prohibited by the Bankruptcy Code.³

¹ James R. Schroll, *Claims for Post-Petition Legal Fees By Unsecured Creditors*, Bankruptcy Law News, Volume XXIV, No. 2 (2009).

² *Id.*

³ *Id.*

“With respect to the issue of reasonableness of attorney’s fees and expenses, the ultimate burden of persuasion is on the secured creditor seeking payment. *In re Cushard*, 235 B.R. 902, 906 (bankr. W.D. Mo. 1999) (citing *Matter of Kennedy Mortgage Co.*, 23 B.R. 466, 474 (Bankr. D. N.J. 1982)). Furthermore, the reasonableness of the fees and expenses to be allowed under §506(b) is a question of federal law. *Id.* (citing *In re Lederman Enterprises Inc.*, 106 B.R. 674, 678 (Bankr. D. Colo. 1989)).”⁴

In re Welzel, 275 F.3d 1308 (11th Cir. 2001)

In *In re Welzel*, 275 F.3d 1308 (11th Cir. 2001), the debtor received a \$1 million loan from the lender that was secured by several mortgages. The loan documents provided that “subject to any limits under applicable law,” lender is entitled to its “cost of collection . . . including fifteen percent (15%) of the principal plus accrued interest and attorney’s fees.” The debtor did not pay the balance due within the time permitted under Georgia state law after receiving a demand for payment from the lender. Subsequently, the debtor filed a chapter 11 petition which was converted into a chapter 7 liquidation. This case involved a solvent debtor and an over-secured creditor.

Prior to applying the eleven factors and reasonableness standard of *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974) to determine whether the itemized fees were reasonable, the *Welzel* court noted that a determination must be made as to whether the claim is allowed under section 502, which provides for the allowance and disallowance of claims. While the lender incurred approximately \$40,000.00 in actual legal fees, the statutory/contractual percentage due to the lender would have resulted in about \$148,000.00 in fees. The bankruptcy court acknowledged that the lender’s fees had vested pre-petition and was therefore an allowed claim under section 502 of the Bankruptcy Code.

The bankruptcy court had ruled that the fees were subject to the reasonableness standard contained in section 506(b) – fees deemed to be reasonable would be treated as a secured claim and the fees deemed unreasonable would be treated as an unsecured claim under section 502. Thus, the fees were to be bifurcated into secured and unsecured claims.

Both parties appealed the bankruptcy court’s order and the district court reversed. The district court held that the portion of fees found unreasonable under section 506(b) were not to be treated as unsecured claims under section 502, but were to be disallowed entirely. The District Court limited the lender’s fees to those actually incurred and disallowed the balance of the claim. A divided 11th Circuit affirmed the district court and held that section 506(b) preempted Georgia statute. Thus, the lender could only recover the fees deemed reasonable and the unreasonable fees were to be disallowed. The lender then requested a rehearing en banc and the panel’s decision was vacated unanimously.

The 11th Circuit agreed with the Fourth, Fifth, Eighth and Ninth Circuits in concluding that section 506(b) does apply, which requires a bankruptcy judge to apply the reasonableness standard when evaluating fees, notwithstanding state law. The court stated that section 506 does not provide for the allowance and disallowance of claims, which is instead governed by section 502. Since none of the grounds for disallowance applied to the lender’s claim for fees, the Eleventh Circuit held that the entire claim should be allowed. The

⁴ Richard P. Carmody, *Caveat Creditor: 506(b) Limits Recoverable Fees, Costs and Charges*, American Bankruptcy Institute, Ethics & Professional Compensation Committee Newsletter, Volume 7, number 6 (2010).

court adopted the “bifurcation framework” and held that the balance of the unreasonable fees should be treated as an unsecured claim.

“After the court has considered the first step under §502, an over-secured creditor’s claim for attorney’s fees can be bifurcated into reasonable fees (to be treated as allowed secured claim) and unreasonable fees (to be treated as an allowed unsecured claim) under §506(b). *Id.* In reading and interpreting the two statutes, the *Welzel* court found that §506 deals with whether a claim is secured or not, as opposed to the larger question of whether the claim is allowed or disallowed, which is addressed by §502. The court explained that because §506(b) simply determines, by analyzing the reasonableness of the fees, whether the fees are secured or not, when §502 deals with allowance, ‘506(b) should be read against the backdrop of general instructions enunciated in Section 502.’ *Id.* at 1317. As a result, §506(b) is ‘meant not to displace the general instructions laid down in §502, but to read together with §502 in a complementary manner.’ *Id.* Thus, the Eleventh Circuit concluded that the “[l]anguage and structure thus demonstrates that §§502 and 506 should be read in tandem with one another, for they address complementary but different questions.”⁵

The court’s ruling that statutorily authorized attorney’s fees cannot be disallowed in bankruptcy may well prevent potential debtors from filing bankruptcy in an effort to avoid state law obligations – attorneys’ fees, interest rate increases and other contractual provisions.

Recent Development in the 5th Circuit
In re 804 Congress, L.L.C., 756 F.3d 368 (5th Cir. 2014)

In *In re 804 Congress, L.L.C.*, 756 F.3d 368 (5th Cir. 2014), Wells Fargo Bank, N.A. (“Wells Fargo”), an over-secured creditor, received relief from the automatic stay to conduct a foreclosure sale on the debtor’s office building. The trustee conducted the non-judicial foreclosure sale of the property and received proceeds in excess of the entire debt owed. The trustee sought to apply the sale proceeds as follows: trustee commission of 5% (approximately \$218,000.00) as provided for under the deed of trust; senior debt of Wells Fargo including pre and post-petition attorney’s fees; debt of junior lienholder; and the remaining balance to the debtor.

The debtor objected to said distribution and the bankruptcy court entered an order directing the sale proceeds to be distributed as follows: 1) \$7,500 trustee’s fee instead of the 5% commission as provided for under the terms of the deed of trust; 2) Wells Fargo debt except for approximately \$87,000 in attorney’s fees; and 3) the junior lien holder in full. The bankruptcy court found Wells Fargo failed to follow proper procedures for obtaining approval of the fees requested. Additionally, the court found that Wells Fargo’s and the trustee’s fees were not reasonable under section 506.

Wells Fargo appealed the bankruptcy court’s order and the district court reversed. The district court held that the bankruptcy court no longer had jurisdiction over the foreclosure sale proceeds once the automatic stay was lifted. The district court concluded that the sale proceeds were governed by Texas law, and ordered that the trustee’s proposed disbursement of the sale proceeds should be implemented.

On appeal, the Fifth Circuit reversed the district court. The Fifth Circuit held that section 506 of the Bankruptcy Code, not state law, governs the amount of fees to be distributed. Therefore, the bankruptcy judge – not the

⁵ Richard P. Carmody, *Caveat Creditor: 506(b) Limits Recoverable Fees, Costs and Charges*, American Bankruptcy Institute, Ethics & Professional Compensation Committee Newsletter, Volume 7, number 6 (2010).

trustee – retains the authority to control the distribution of the foreclosure sales proceeds. The court agreed with the *Welzel* court which found that the language of section 506(b) doesn't suggest that "just because a given fee arrangement is enforceable under state law, it should be exempt from the reasonableness standard," *In re Welzel*, 275 F.3d 1308, 1314.

The court reviewed whether it should matter that the collateral at issue in this case was sold at a non-judicial foreclosure sale following relief from the automatic stay. However, the court stated that such facts did not change its ruling because section 506 does not distinguish between proceeds generated from a foreclosure sale permitted by the bankruptcy court versus a sale under the court's supervision. In other words, the creditors were not insulated from section 506 and the reasonableness standard therein. The court also cited *Blackburn-Bliss Trust v. Hudson Shipbuilders, Inc.*, 794 F.2d 1051 (5th Cir. 1986) as support for its analysis.

The trustee and Wells Fargo also argued that any part of the commission or fees that were not found recoverable under section 506 could be recovered as unsecured claims under Section 502. However, the Fifth Circuit refused to rule on this issue because it was not adequately preserved on appeal. The court pointed out that First, Ninth and Eleventh Circuit Courts have stated that the over-secured creditor's fee found to be unreasonable is otherwise recoverable as an unsecured claim pursuant to section 502.

Over-secured creditors would be wise to detail all legal fees, costs and expenses with supporting documentation. Bills for services supported by time records often, but not always, suffice. Additionally, if a contract provides for fees and costs, lenders may consider including the same language in a relief from stay order or other stipulation, to avoid the need for further court proceedings related to legal fees.

About Christian & Small LLP

[Christian & Small LLP](#) represents a diverse clientele throughout Alabama, the Southeast and the nation with clients ranging from individuals and closely held businesses to Fortune 500 corporations. By matching [highly experienced lawyers](#) with specific client needs, Christian & Small develops innovative, effective and efficient solutions for clients. Christian & Small focuses on the [areas of litigation and business](#). The firm is a member of the [International Society of Primerus Law Firms](#) and the only Alabama member firm in the [Leadership Council on Legal Diversity](#). Please visit www.csattorneys.com for more information.