Yes, but Don't Forget the Kitchen Sink: Secured Creditors' Right to Recover Principal + Interest + Default Interest + Original Issue Discount + Late Fees + Prepayment Premiums + Fees + Expenses

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I. Make-Whole Premiums in Bankruptcy

A make-whole premium, or prepayment fee, is a payment that is required to be made by a debtor upon the prepayment of a loan. Many bond indentures or loan agreements require a borrower to pay the lender a fee upon prepayment of a loan. The purpose of the fee is to compensate the lender for loss of the lender's expected yield on interest. For example, if a borrower repays a loan with a high interest rate at a time when interest rates are lower, the lender will no longer receive the higher interest rate and must reinvest the prepaid funds at the lower interest rates. Make-whole premiums are designed to compensate the lender for this loss.[1]

Make-whole provisions can take several forms. Some provisions, commonly found in bond indentures, contain a formula that is designed to approximate actual damages by trying to calculate the difference between the present value of the lost interest payments and the amount that the lender would receive if the funds were reinvested at current interest rates. Other provisions, commonly found in loan agreements, provide for payment of a make-whole premium based on a fixed percentage of the amount that is prepaid. For instance, a loan agreement may require a prepayment fee of 3% in year 1, 2% in year 2, or 1% in year 3.

Early cases to address the issue focused on whether the claim for the make-whole premium was a valid claim for liquidated damages or whether the claim should be disallowed as a claim for unmatured interest under Section 502(b)(2). More recently, litigation has focused on whether the make-whole provision is triggered at all where the debt is automatically accelerated upon a bankruptcy case. In these cases, courts consider whether a payment made after the debt has been accelerated can be considered a prepayment where the payment is made after the new accelerated maturity date.

Accordingly, in order to obtain an allowed make-whole claim in bankruptcy, a secured creditor will have to address the following issues:

1. Is the make-whole payment contractually required where the debt is automatically accelerated upon the bankruptcy filing?

2. Even if the make-whole premium is contractually required, should the make-whole claim be disallowed as unmatured interest under Section 502(b)(2) or is the claim one for liquidated damages?

[1] Make-whole provisions should be distinguished from no-call provisions. A make-whole provision requires a borrower to pay a premium upon prepayment. A no-call provision prohibits the borrower from prepaying the obligations at all. This paper does not address issues regarding whether a creditor is entitled to a claim for a breach of a no-call provision. Some courts have held that a lender is entitled to an unsecured claim for expectation damages for breach of a no-call provision, at least where the debtor is solvent. *Premier Entm't Biloxi LLC v. U.S. Bank Nat'l Ass'n (In re Premier Entm't Biloxi LLC)*, 445 B.R. 582 (Bankr. S.D. Miss 2010). Other courts hold that a no-call provision is unenforceable in bankruptcy and, therefore, cannot serve as the basis for a claim. *HSBC Bank USA, Nat'l Ass'n v. Calpine Corp.*, No. 07 Civ. 3088, 2010 WL 3835200 (S.D.N.Y. Sept 15, 2010).

3. If the claim is for liquidated damages, is the claim allowable under state law?

4. Is the amount of the make-whole premium reasonable for purposes of Section 506(b)?

As discussed in more detail below, the clear recent trend is for courts to conclude that a make-whole provision is not triggered where the loan is automatically accelerated by the bankruptcy filing unless the loan agreement expressly provides that the make-whole provision is to apply upon acceleration. Courts are divided on the remaining issues.

A. Is the Make-Whole Premium Contractually Required?

Much of the recent litigation has focused on the issue of whether a make-whole premium is contractually required when the amount owed has been accelerated. The purpose of a make-whole provision is to require the debtor to pay a premium if the amount owed is prepaid prior to the maturity date. If the maturity date of the loan is accelerated, then the entire amount of the loan becomes immediately due and payable, and any subsequent payment is not a prepayment. Several courts have relied on this reasoning to conclude that a make-whole payment is not required where the debt is automatically accelerated upon a bankruptcy filing unless the loan agreement expressly provides that the make-whole premium will be due in the event of acceleration. As shown by the cases discussed below, the outcome of this issue depends upon the language used in the applicable loan documents.

One of the first cases to address the issue was *In re Solutia, Inc.*, 379 B.R. 473 (Bankr. S.D.N.Y. 2007). In *Solutia*, the Bankruptcy Court ruled that the make-whole provision was not triggered because it did not expressly provide for payment of a premium in the event of automatic acceleration. According to the court in *Solutia*:

> By incorporating a provision for automatic acceleration, the 2009 Noteholders made a decision to give up their future income stream in favor of having an immediate right to collect their entire debt. Because the 2009 Notes were automatically accelerated, any payment at this time would not be a prepayment. Prepayment can only occur *prior* to the maturity date. Here payment will be a postmaturity date repayment. This court need not concern itself with the enforceability of prepayment premiums in bankruptcy.

Id. at 488 (internal citations omitted). The court went on to say that it would be possible to contractually provide for post-acceleration yield maintenance but that the bond indenture at issue did not have "the explicitness that would be expected in a typical post-acceleration yield maintenance clause." *Id.*

The bankruptcy court in *In re Chemtura Corp.*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010) addressed the issue in the context of a settlement motion. In *Chemtura*, the debtor

proposed a plan that contained a settlement of the bondholders' make-whole claim. The debtor proposed to pay the bondholders an amount equal to approximately 42% of the amount that would be payable if the make-whole provision were found to be enforceable. The equity committee objected to the settlement by relying on *Solutia* to argue that there was no reason to offer the bondholders any amount to settle the make-whole claim. In finding that the settlement was reasonable, the court concluded that the bondholders had the better argument on the make-whole issue. *Id*. at 601. To distinguish *Solutia*, the court focused on the precise language of the indenture at issue. The indenture required payment of the make-whole premium if payment was made prior to the "Maturity Date." The Maturity Date was defined as a specific day. Thus, because the agreement required payment of the make-whole premium before a specific date as opposed to simply requiring payment of the premium upon prepayment prior to maturity, the court concluded that it was reasonable for the debtor to settle the make-whole dispute with the bondholders. *Id*.

More recent decisions have followed the *Solutia* approach to conclude that a make-whole provision is not triggered where the debt is automatically accelerated upon a bankruptcy filing and the loan documents do not expressly require payment of the premium upon acceleration. First, in the bankruptcy case of *MPM Silicones*, the bankruptcy court concluded that payment of the make-whole premium was not required because the indenture did not "clearly and specifically" provide for payment of the make-whole upon acceleration. *In re MPM Silicones, LLC*, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014). This decision was recently upheld on appeal by the District Court. *US Bank National Ass'n v. Wilmington Savings Fund Society, FSB (In re MPM Silicones, LLC)*, No. 14 CV 7471, 2015 WL 2330761 (S.D.N.Y. May 4, 2015). As the District Court stated:

> Generally, a lender forfeits the right to a prepayment consideration by accelerating the balance of the loan. The rationale most commonly cited for this rule is that acceleration of the debt advances the maturity date of the loan, and any subsequent payment by definition cannot be a prepayment. However, courts recognize an exception to this rule "when a clear and unambiguous clause ... calls for payment of the prepayment premium."

Id. at * 4 (citing *U.S. Bank Nat'l Ass'n v. S. Side House, LLC*, 2012 WL 273119, at *4 (E.D.N.Y. Jan.30, 2012)). The District Court further noted that the acceleration clauses at issue did not "clearly an unambiguously" require payment of the make-whole premium.

In the *Energy Future Holdings* bankruptcy, Judge Sontchi in Delaware recently followed the decisions in *MPM Silicones*. *See Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, No. 14-50363, 2015 WL 1361136 (Bankr. D. Del. March 26, 2015). Applying Colorado law, the Fifth Circuit Court of Appeals also recently reached the same conclusion. *Bank of NY Mellon v. GC Merchandise Mart, LLC (In re Denver Merchandise Mart, Inc.)*, 740 F.3d 1052

(5th Cir. 2014). These cases demonstrate the importance of clearly providing in the applicable loan document that the make-whole premium is required even in the event of acceleration.

In other cases, the applicable loan documents expressly provided that the make-whole premium would be owed in the event of acceleration. For instance, in *In re School Specialty, Inc.*, No. 13-10125, 2013 WL 1838513 (Bankr. D. Del. Apr. 22, 2013), the applicable loan agreement required payment of an early payment fee "[u]pon either prepayment or acceleration of the Term Loan . . ."). *In re GMX Resources Inc.*, No. 13-11456 (Bankr. W.D. Okla. Aug. 27, 2013) (oral decision). Similarly, and not surprisingly, courts have held that no make-whole premium is due when the applicable loan documents expressly provide that no make-whole premium is required to be paid in the event of automatic acceleration. *See US Bank Trust Nat'l Ass'n v. AMR Corp. (In re AMR Corp.)*, 730 F.3d 88, 98-105 (2d Cir. 2013), *aff'g US Bank Trust Nat'l Ass'n v. American Airlines, Inc. (In re AMR Corp.)*, 485 B.R. 279 (Bankr. S.D.N.Y. 2013).

As these cases demonstrate, the outcome of this issue in any particular case is dependent upon the language in the applicable loan documents. In order to pursue a make-whole claim, the secured creditor must be able to show that the applicable loan documents clearly provide for payment of the make-whole premium in the event of automatic acceleration. Making this showing, however, does not guarantee recovery. The secured creditor must also prevail on the issued discussed below.

B. Is the Make-Whole Premium a Claim for Unmatured Interest or Liquidated Damages?

Even if the make-whole premium is contractually required, a debtor may argue that the claim should nevertheless be disallowed under Section 502(b)(2) as a claim for unmatured interest. Cases are divided on this issue.

Some courts conclude that make-whole premiums are proxies for unmatured interest because they generally seek to compensate a lender for future interest payments due to early repayment of debt. *In re Ridgewood Apartments of DeKalb County, Ltd.*, 174 B.R. 712, 720 (Bankr. S.D. Ohio 1994) ("As an attempt to compensate the lender for potential loss in interest income, Fannie Mae's claim for a prepayment penalty is not allowed under 11 U.S.C. § 502(b)(2)."); *HSBC Bank USA, Nat'l Ass'n v. Calpine Corp.*, No. 07 Civ. 3088, 2010 WL 3835200 at * 5 (S.D.N.Y. Sept. 15, 2010).

Other courts conclude that claims based on make-whole provisions represent liquidated damages, which fully mature once triggered by the prepayment. In the case of *In re Trico Marine Servs., Inc.,* 450 B.R. 474 (Bankr. D. Del. 2011), the court stated as follows:

> Research reveals that the substantial majority of courts considering this issue have concluded that make-whole or prepayment obligations are in the nature of liquidated damages rather than unmatured interest, whereas courts taking a contrary approach are distinctly in the minority. *Noonan v. Fremont Fin. (In re Lappin Elec. Co.)*, 245 B.R.

> 326, 330 (Bankr. E.D. Wis. 2000) ("[T]his court is in agreement with a majority of courts that view a prepayment charge as liquidated damages, not as unmatured interest or an alternative means of paying under the contract.") (citations omitted); see also *In re Outdoor Sports Headquarters, Inc.*, 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993) ("Prepayment amounts, although often computed as being interest that would have been received through the life of a loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract .") (citations omitted); *In re Skyler Ridge*, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987) ("Liquidated damages, including prepayment premiums, fully mature at the time of breach, and do not represent unmatured interest.") (citation omitted).

Trico Marine, 450 B.R. at 480–81. This reasoning was also followed in the case of *In re School Specialty, Inc.*, No. 13-10125 2013 WL 1838513 (Bankr. D. Del. Apr. 22, 2013).

C. If Treated as a Claim for Liquidated Damages, is Claim Allowable Under State Law?

If the claim is treated as a claim for liquidated damages, the court must determine whether the liquidated damages claim is enforceable under state law. In *School Specialty*, the court applied New York law and stated that a make-whole premium was an enforceable liquidated damages claims when "(i) actual damages are difficult to determine, and (ii) the sum stipulated is not 'plainly disproportionate' to the possible loss." *In re School Specialty, Inc.*, 2013 WL 1838513, at *2. The court stated further that in determining whether the loss was "plainly disproportionate" it would consider "(i) whether the prepayment fee is calculated so that the lender will receive its bargained-for yield and (ii) whether the prepayment fee is the result of an arms-length transaction between represented sophisticated parties." *Id*. The court in *School Specialty* ultimately held that the prepayment premium was an enforceable claim for liquidated damages under New York law.

A similar result was reached in the case of *In re Hidden Lake Ltd. Pshp.*, 247 B.R. 722, 724-25 (Bankr. S.D. Ohio 2000). In *Hidden Lake*, the court concluded that the prepayment premium was an enforceable liquidated damages provision because it was intended to compensate the lender for lost yield given the early payment. In reaching this conclusion, the court stated as follows:

> This Court finds that the prepayment clause in the Amended Note executed by the Debtor and Aetna provided compensation to Aetna in the event of a breach by the Debtor which attempted to estimate probable damages under most circumstances. Although the amount of damages calculation under the yield maintenance formula generally would overcompensate Aetna, the amount of that

> overcompensation, given the uncertainties accompanying the prediction of probable actual damages, was not so great that this Court could find, as a matter of law, that the prepayment clause was intended to punish the Debtor rather than compensate Aetna. There is no dispute that both parties were knowledgeable, had a reasonable chance to understand the terms of the agreement and were sufficiently sophisticated and experienced to be aware of the import of their agreement.

Id. at 729.

In contrast, courts have concluded that a make-whole premium is not an enforceable liquidated damages clause if it is not calculated in a way that compensates a lender for lost yield. For instance, in *In re A.J. Lane & Co.*, 113 B.R. 821 (Bankr. D. Mass. 1990), the court refused to enforce a make-whole premium equal to a fixed percentage of the prepayment. The court first noted that the provision was not designed to approximate actual damages. The court also concluded that damages would not be difficult to calculate at the time of the breach. According to the court, "The damage formula is simple and well established. It is the difference in the interest yield between the contract rate and the market rate at the time of prepayment, projected over the term of the loan and then discounted to arrive at present value." *Id*. at 829.

In other cases, courts refused to enforce make-whole provisions where the formula for calculating the premium was not designed to compensate the lender for lost yield. In both *In re Kroh Bros. Dev. Co.*, 88 B.R. 997, 1000 (Bankr. W.D. Mo. 1988) and *In re Skyler Ridge*, 80 B.R. 500, 505 (Bankr. C.D. Cal. 1987), the courts concluded that a make-whole premium was not an enforceable liquidated damages claim where the amount of the premium was to be calculated by multiplying the amount of the prepayment by the number of years left on the loan and the difference between the current interest rate on the loans and the current yield on U.S. Treasury notes. Among other things, the courts noted that the provision did not require the lost yield to be discounted to present value.

Other courts have determined that make-whole premiums are valid liquidated damages claims even where they are based on fixed percentages or formulas similar to those at issue in *Kroh Bros.* and *Skyler Ridge*. For instance, in *In re Schaumberg Hotel Owner Ltd. Partnership*, 97 B.R. 943 (Bankr. N.D. Ill. 1989), the bankruptcy court held that a prepayment fee equal to 10% of the outstanding principal amount was a valid liquidated damages clause. In *Schaumberg*, the court stated: "The parties are not required to make the best estimation of damages, just one that is reasonable. It is immaterial that the actual damages suffered are higher or lower than the amount specified in the clause." *Id*. at 953.

Similarly, in *In re Financial Center Assocs.*, 140 B.R. 829, 839 (Bankr. E.D.N.Y. 1992), the court held that the same provision at issue in *Kroh Bros.* and *Skyler Ridge* was a valid liquidated damages clause, even though the formula resulted in a prepayment fee equal to approximately 25% of the amount of the owed. The court refused to follow *Skyler Ridge* because "Skyler ridge appears to limit the freedom of contract of the parties

by replacing the parties' judgment regarding the appropriate discount rate with the court's view of the appropriate discount rate." *Id*. at 837.

As these cases demonstrate, a make-whole premium that is calculated in a manner that is designed to compensate the lender for lost yield is most likely to be viewed by the court as a valid liquidated damages claim. A claim that is based on a set percentage or some other formula is more susceptible to attack, although some courts do allow these claims.

These decisions also demonstrate an inherent tension between the liquidated damages issue and the issue of whether the claim should be disallowed as unmatured interest under Section 502(b)(2). The make-whole premium that is most likely to be viewed as a liquidated damages claim under applicable state law is the make-whole premium that is designed to compensate the lender for lost yield. But if the claim is designed to compensate the lender for lost yield, then the claim appears to be a claim for unmatured interest that may be disallowed under 502(b)(2). In contrast, the make-whole premium that is based on a set percentage may look more like a fee or charge for purposes of 502(b)(2) but may face more difficulty being viewed as an enforceable liquidated damages claim under state law.

D. Is the Amount of the Claim Reasonable Under Section 506(b)?

Even if the claim is treated as an enforceable liquidated damages claim, there is the issue of whether the amount of the claim is reasonable under Section 506(b). At the outset, there is the question of whether the analysis for purposes of Section 506(b) is any different than the state law liquidated damages analysis. Some cases suggest that if a claim is a valid liquidated damages claim under state law, then it is also reasonable for purposes of Section 506(b). *See In re School Specialty, Inc.*, 2013 WL 1838513, at *5. Other courts, conclude that Section 506(b) imposes an additional "reasonableness" requirement in addition to the requirement that a claim be valid under applicable state law. *In re Morse Tool, Inc.*, 87 B.R. 745, 748-50 (Bankr. D. Mass 1988) ("a charge within the purview of section 506(b) must be enforceable under state law . . . and must be reasonable within the meaning of section 506(b)").

As a practical matter, this issue arises mainly in the context of those cases discussed above where courts found a claim to be a valid liquidated damages claim under state law even though the amount of the claim was based on a fixed percentage or formula that potentially overcompensated the creditor. In these cases, the court must determine whether the amount of a claim is reasonable under Section 506(b) even if it will mean that the secured creditor will receive more than the future yield it lost because of the prepayment.

For instance, in *In re Financial Center Assocs.*, the court allowed a liquidated damages claim equal to approximately 25% of the amount of the owed. Finding that this was reasonable for purposes of Section 506(b), the court stated that the reasonableness of Section 506(b) was only "a safety value which must be used cautiously and sparingly." *In re Financial Center Assocs.*, 140 B.R. at 839.

A different result was reached in the case of *In re Duralite Truck & Body Container Corp.*, 153 B.R. 708 (Bankr. D. Md. 1993). In that case, the court agreed with

Financial Center Assocs. that a prepayment fee could be a liquidated damages claim under New York law even if it did not approximate actual damages. However, the court concluded that for purposes of Section 506(b), the claim did need to approximate actual damages. The court ultimately concluded that the prepayment charge at issue was not reasonable under Section 506(b).

II. Recovery of OID in Bankruptcy

The original issue discount (OID) of a note is the difference between the face value of the note due upon redemption and the discounted price paid by investors when the note is issued. For instance, a note with a face amount of $1,000 might sell for only $900 when issued. The $100 discount to par represents OID. The reason for this $100 OID is that the future interest payments, by themselves, are insufficient to compensate the investors for the risk incurred. Thus, OID is a form of additional yield. For tax and accounting purposes, OID is treated as deferred interest.

Because OID represents a form of deferred interest, OID on newly issued notes is treated as unmatured interest and is, therefore, subject to disallowance under Section 502(b)(2). *LTV Corp. v. Valley Fid. Bank & Trust Co. (In re Chateugay Corp.)*, 961 F.2d 378, 380 (2d Cir. 1992). The issue becomes more complicated, however, in the context of debt exchanges.

In *Chateugay*, the court addressed how claims for OID should be treated in the case of a face value exchange. Prior to filing for bankruptcy, LTV issued $150 million of bonds that had an initial OID of approximately $13 million. Shortly before it filed for bankruptcy, LTV exchanged $116 million of these bonds for bonds with the same face amount but a higher interest. The exchange created additional OID. After LTV filed for bankruptcy, the holders of the new notes filed claims for the full face amount of the notes without deducting for unamortized OID. The debtors objected to the claims and asserted that the OID should be disallowed as unmatured interest under Section 502(b)(2). The bankruptcy court disallowed the OID claim, and the district court affirmed. On appeal, the Second Circuit concluded that the OID attributable to the original notes should be disallowed but that the additional OID created upon the exchange should not be disallowed. *In re Chateaugay Corp.*, 961 F.2d 380-383.

In its decision, the Second Circuit relied primarily on policy arguments. According to the court, if additional OID created in an out-of-court debt exchange was not allowed in bankruptcy, then creditors would not have any incentive to participate in out-of-court exchanges. *Id*. at 382 (noting that the lower court decisions "create[d] a disincentive for creditors to cooperate with a struggling debtor). The Fifth Circuit subsequently reached the same conclusion. *Texas Commerce Bank N.A. v. Licht (In re Pengo Industries)*, 962 F.2d 543 (5th Cir. 1992).

In *Chateugay*, the court was confronted with a face value exchange and left undecided whether a fair market value exchange would be entitled to the same treatment. *In re Chateaugay Corp.*, 961 F.2d at 382 ("[t]he bankruptcy court's decision might make sense in the context of a fair-market-value exchange, where the corporation's overall debt obligations are reduced.").

The issue related to additional OID created in a fair market value exchange was recently addressed in the *ResCap* bankruptcy. *In re Residential Capital, LLC,* 501 B.R. 549 (Bankr. S.D.N.Y. 2013). In *ResCap*, the debtor had exchanged more than $6 billion of notes for cash and new junior secured notes with a face amount that was only 80% of the original amount of the notes. The value of the new junior secured notes was determined by a modified Dutch auction. Ultimately, the value of the new notes was determined to be less than the face amount of the new junior secured notes. At the time of the bankruptcy filing, this new OID resulted in a claim of approximately $386 million. After numerous parties objected, the Bankruptcy Court relied on the reasoning of *Chateaugay* to overrule the objections. According to the court, the two types of exchanges were virtually identical, and the policy of encouraging consensual exchange offers to avoid bankruptcy applied to both types of exchanges. *Id*. at 588 ("The Court thus concludes that there is no commercial or business reason, or valid theory of corporate finance, to justify treating claims generated by face value and fair value exchanges differently in bankruptcy.") While the issue was on appeal, the parties settled as part of a global settlement.

Based on *Chateaugay* and *ResCap*, although OID on newly issued notes may be disallowed as unmatured interest, when those notes are exchanged (either in a face value or fair value exchange) and additional OID is created, that additional OID should not be disallowed. This provides comfort to creditors who participate in a debt exchange that they will not be worse off in bankruptcy than they would have been had they not participated in the exchange.

III. Default Interest, Late Fees, and Legal Fees

a. Interplay of Sections 502 and 506(b):

Section 502 of the Bankruptcy Code provides that "[a] claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . objects." 11 U.S.C. § 502(a). Section 502 further provides if an objection to a claim is made, the court shall determine the amount of the allowed claim as of the date of the filing of the petition, except to the extent that one of the exceptions enumerated in § 502(b) applies to the claim. 11 U.S.C. § 502(b). The court shall allow the claim unless,

> (1) such claim is unenforceable against the debtor . . . under any agreement or applicable law for a reason other than because such claim is contingent or unmatured;
>
> (2) such claim is for unmatured interest;
>
> (3) if such claim is for a tax assessed against property of the estate, such claim exceeds the value of the interest of the estate in such property;
>
> (4) if such claim is for services of an insider or attorney of the debtor, such claim exceeds the reasonable value of such services;
>
> (5) such claim is for a debt that is unmatured on the date of the filing of the petition and that is excepted from discharge under section 523(a)(5) of this title;
>
> (6) if such claim is the claim of a lessor for damages from the termination of a lease of real property . . . ;

(7) if such claim is the claim of an employee for damages resulting from the termination of an employment contract . . . ;

(8) such claim results from reduction, due to late payment, in the amount of . . . credit available to the debtor in connection with an employment tax on wages, salaries, or commissions earned from the debtor; or

(9) proof of such claim is not timely filed . . . .

11 U.S.C. § 502(b).

If an objection to a claim is made, the Bankruptcy Court will determine the amount of the allowed claim as of the date of the filing of the petition, except to the extent that one of the exceptions enumerated in § 502(b) applies to the claim. *In re Holden*, 491 B.R. 728 (Bankr. EDNC 2013) The party in interest objecting to a claim filed under 11 U.S.C.S. § 502 must introduce evidence to rebut the claim's presumptive validity. If the party in interest introduces evidence that rebuts the claim's validity, the creditor has the ultimate burden of proving the amount and validity of the claim by a preponderance of the evidence.

b. Default Interest

Upon the filing of a debtor's bankruptcy petition, creditors are concerned with more than whether they can recover the principal amount owed on the date of bankruptcy. Of primary concern also is whether the creditor can collect 1) pre and post-interest on their claim during the pendency of the bankruptcy case, and 2) other charges incurred in connection with the bankruptcy case.

i. Under-Secured Creditor Claims

While section 506(b) of the Bankruptcy Code allows over-secured creditors to potentially recover interest and "any reasonable fees, costs, or charges…" the Bankruptcy Code does not include a similar code section providing for the recovery by unsecured creditors of post-petition interest, fees, costs, and charges.

Upon the filing of a bankruptcy petition, interest ceases to accrue under general equitable principles of insolvency law. *Vanston Bondholders Prot. Comm. v. Green*, 329 U.S. 156 (1946). The U.S. Supreme Court in *Vanston* proclaimed that the reasons for this rule are as follows: "'(1) post-petition interest is a penalty imposed for a delay of payment required by law to allow the preservation and protection of the estate for the benefit of all interests, (2) the rule avoids the administrative inconvenience of continuously re-computing claims, and (3) it avoids the gain or loss as between creditors whose obligations bear different interest rates or who receive payment at different times.' *Id. at 163-64*.

Since, for bankruptcy liquidation and plan purposes, interest on unsecured and under-secured claims does not accrue during the pendency of the bankruptcy case, unsecured creditors have also traditionally been unable to recover attorneys' fees, even when provided for in the "bargained for" pre-petition loan documents.

This rule is currently embodied in Bankruptcy Code section 502(b)(2), which disallows a claim for unmatured interest. The rule does not, however, apply to an over-secured creditor who is entitled to post-petition interest up to the value of its collateral.

See Vanston, 329 U.S. at 164. This exception is now contained in *11 U.S.C. § 506(b)*." *In re 785 Partners, LLC*, 470 B.R. 126, at 133-134 (Bankr. S.D.N.Y. 2012).

ii. Over-Secured Creditors' Claims

Lenders often require borrowers to agree to pay a higher interest rate, commonly called the "default rate," following an event of default as defined in the loan documents. The default rate that a lender may charge a borrower is determined by the loan documents, as may be limited by applicable state usury and other laws. Additionally, lenders usually require borrowers to pay a fee in the event of a late payment. This late payment fee/premium or "late fee" is in theory intended to compensate the lender for, among other things, the additional administrative expense of handling the late payment.

(a) Pre-Petition Default Interest

In *In re 785 Partners, LLC*, 470 B.R. 126 (Bankr. S.D.N.Y. 2012), the debtor filed for bankruptcy protection under chapter 11 in the Southern District of New York. The dispute between the 785 Partners and First Manhattan focused, among other issues, on: 1) the allowance of both pre-petition interest and post-petition interest at the default rate, 2) attorneys' fees, and 3) the late payment fee. The secured creditor held a secured claim of approximately $100 million, $81 million of which was principal, $7 million of which was pre-petition contract interest (at 5%), plus another $8 million of which was default interest (at an additional 5%) and another $3.8 million of which was for a late payment fee. The collateral was a building in Manhattan with a market value of $91.7 million, plus the $18 million escrow reserve. Clearly then, the creditor was indeed over-secured.

The court in *785 Partners* held that not only is pre-petition contractual interest allowed to the extent permitted under state law, but that ". . . it is well settled that an agreement to pay interest at a higher rate in the event of default or maturity is an agreement to pay interest and not a penalty." *Jamaica Sav. Bank, FSB v. Ascot Owners, Inc.,* 665 N.Y.S.2d 858, 858 (N.Y. App. Div. 1997) (internal citation omitted) ('[A]n agreement to pay interest upon a loan from its date until its payment at a rate before and a differing rate after its maturity is an agreement to pay interest and not a penalty as to the latter rate.'") *In re 785 Partners LLC*, 470 B.R. at 131.

The court in *785 Partners* stressed that "[a] higher default interest rate reflects the allocation of risk as part of the bargain struck between the parties, a bargain that benefits the obligor as well as the obligee." *Id* at 131. Additionally, the court noted that a judge cannot adjust the pre-petition claim and rewrite the parties' bargained for agreement "based on its own notions of fairness and equity." *Id. See Cruden v. Bank of N.Y.,* 957 F.2d 961, 976 (2nd Cir. 1992) ("A court may neither rewrite, under the guise of interpretation, a term of the contract when the term is clear and unambiguous . . . nor redraft a contract to accord with its instinct for the dispensation of equity upon the facts of a given case.") The *785 Partners* court further pointed out that it was even less inclined to rewrite the parties' bargained for exchange in the context of real property when the negotiation was between parties deemed to be sophisticated.

The *785 Partners* court also quickly dismissed debtor's final argument that the lender should not be entitled to pre-petition interest at the default rate because the present

over-secured creditor was a debt buyer who had purchased the loan from the original lender, noting that the over-secured creditor was the assignee of the original lender, and therefore stood in the original lenders' shoes vis-à-vis the debtor. The court noted too that, although "the [d]ebtor's existing default may have been factored into the price that [creditor] paid to the [o]riginal lenders," that was "a matter between those parties." *785 Partners*, 470 B.R. at 133. Accordingly, the court found that the over-secured creditor was entitled to collect pre-petition interest at the default rate, based upon the pre-petition default by the debtor and the provision for the default rate in the loan documents.

(b) Post-Petition Interest and Default Interest for the Over-Secured Creditor

While pre-petition interest is permitted to the extent allowed under applicable non-bankruptcy law, as stated, the general rule is that post-petition interest and expenses are not an allowed component of a creditor's claim under section 502(b)(2) of the Bankruptcy Code. However, section 506(b) of the Bankruptcy Code modifies this general rule by its treatment of over-secured claims in bankruptcy. Section 506(b) provides as follows:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or [s]tate statute under which such claim arose. (emphasis supplied)

Of course, a determination must first be made that a creditor is truly over-secured before such recoveries will be permitted. Section 506 goes on to define a secured claim as one "secured by a lien on property in which the [debtor's] estate has an interest, or that is subject to set-off under §553" of the Bankruptcy Code. 11 U.S.C. §506(a)(1). Section 506 then further states that a secured claim is over-secured if the value of the collateral exceeds the amount of the creditor's claim. *Id.*

Bankruptcy courts generally require that interest, fees, costs, and charges are appropriately granted to over-secured creditors under section 506(b) only when the creditor satisfies four elements: (1) the creditor's claim is an allowed secured claim; (2) the creditor is indeed over-secured (after section 506(c) recoveries); (3) the fees, costs and charges are reasonable; and (4) the fees, costs and charges are provided for under the agreement." *See generally, In re Staggie,* 255 B.R. 48, 51 (Bankr. D. Idaho 2000), superseded on other grounds by statute; *In re Vladez*, 324 B.R. 296, 299-300 (Bankr. S.D. Tex. 2005); *In re Woods Auto Gallery Inc.*, 379 B.R. 875, 884 (Bankr. W.D. Mo. 2007).[2]

[2] 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).

(c) Upon What Date Is Interest Payable to the Over-Secured Creditor

The First Circuit recently held in *In re SW Boston Hotel Venture, LLC* 2014 U.S. App. LEXIS 6768 (1st Cir. 2014) that a secured creditor must present clear evidence of its over-secured status for the entire period that default interest is sought. The court acknowledged a circuit split on the issue of whether to apply a flexible or single-valuation approach in determining the value of collateral. The single-valuation approach involves a determination of the over-secured status at a fixed point in time – the petition date or confirmation date. The flexible approach, which the First Circuit adopted, allows the bankruptcy court discretion to determine the appropriate measuring date on a case by case basis.

In *SW Boston*, the debtor owned real estate which the creditor had a lien against. The real estate was sold while the bankruptcy case was pending for an amount that was greater than the creditor's lien. The court was asked whether the creditor should be treated as an over-secured creditor for the pendency of the case, or whether the creditor should be treated as over-secured for the post-sale period. The court held that due to the creditor's failure to set forth any evidence of its over-secured status during the pendency of the case, the creditor was only entitled to interest at the default rate from the date of the sale until confirmation of the plan.

(d) Presumption of Contract Rate for Over-Secured Creditor is Entitled to Default Interest

While Bankruptcy Code section 506(b) governs the provision of interest to over-secured creditors, it is silent regarding the appropriate interest calculation to be used by the courts. However, a majority of courts have applied the rebuttable presumption that that the over-secured creditor is entitled to default interest at the contract rate, post-petition, and that the debtor bears the burden of rebutting that presumption. *In re 785 Partners, LLC*, 470 B.R. at 134. *See also In re Terry Ltd. P'ship*, 27 F.3d 241, 243 (7th Cir. 1994).

The equitable factors to be considered when determining whether the over-secured creditor is entitled to interest at the default rate include: (i) whether there has been creditor misconduct;[3] (ii) whether the application of the default interest rate would harm unsecured creditors;[4] (iii) does the default interest rate constitute a penalty;[5] or (iv) will the application of the default interest rate impair the debtor's "fresh start." *In re Gen. Growth Properties, Inc.*, 451 B.R. 323, 328 (Bankr. S.D.N.Y. 2011).

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[3] The court in *In re SW Boston Hotel Venture, LLC*, 748 F.3d 393, 415 (1st Cir. 2014) did not find misconduct by the creditor simply because it asserted its rights against the debtor.

[4] The court in *General Growth Properties, Inc.* 451 B.R. at 328 found that the unsecured creditors would not be harmed by the application of the default interest rate because the debtor was solvent and the creditors were being paid in full.

[5] The court in *In re Bownetree, LLC*, 2009 WL 2226107 (Bankr. E.D. N.Y. 2009) found the 25% default rate unenforceable because the spread between it and the non-default rate was unexplainable, among other reasons.

The bankruptcy court in *785 Partners* found (1) no evidence of misconduct by the secured creditor; (2) that the application of the default rate would not harm unsecured creditors because they were getting paid in full; (3) that the default rate would not impair the debtor's "fresh start;" and (4) the court determined that the default rate did not constitute a penalty under New York law.

The *785 Partners* court noted that the "Bankruptcy Code does not provide guidance when a default interest rate will be deemed a penalty, and the issue should turn on applicable non-bankruptcy law." 4 *Collier On Bankruptcy*, §506.04[2][b], at 506-104 (quoting*785 Partners,* 470 B.R. at 135). While the court agreed that a higher default rate of interest has a penal effect in that it compels timely payments – if you default, you pay more – such an increase was designed to compensate the creditor for the increased risk of non-payment and the costs associated therewith. Courts are typically reluctant to find a default rate unenforceable when it is included in the bargained for contract between sophisticated parties.

Importantly, the court in *785 Partners* explained that determining whether the default rate constituted a penalty or not must be determined as of the date of the agreement and not once the debtor has filed for bankruptcy protection. The court in *785 Partners* stated that it was even more reluctant to rewrite the contract since the debtor was solvent and decreasing the interest rate would only result in a windfall to equity. *See also In re Johns-Manville Corp.*, 845 F.Supp. 2d 584 (S.D.N.Y. 2012) ("New York law is clear that subjective notions of fairness or equity are not permissible basis for a court to rewrite a contract or to excuse compliance with conditions precedent"). Accordingly, the court in *785 Partners* determined that the over-secured creditor was entitled to post-petition interest at the default rate.

In *In re Residential Capital, LLC*, 508 B.R. 851 (Bankr. S.D.N.Y. 2014), Residential Capital, owned by Ally Financial ("ResCap"), and certain affiliates entered into a loan agreement with Citibank for a $700 million secured revolving credit facility, which was subsequently amended ten (10) different times. ResCap eventually filed for chapter 11 bankruptcy protection in 2012 and Citibank, as an over-secured creditor, sought to recover interest at the default rate in addition to legal fees and expenses. According to Citibank, the difference between the non-default interest it received and the default interest it claimed was approximately $4.5 million.

Residential Capital is instructive because the bankruptcy court for the Southern District of New York refused to establish a bright-line-rule that would deny an over-secured creditor the right to collect post-petition interest at the default rate from an insolvent debtor. Significantly, the case hails from a jurisdiction where many large commercial bankruptcy cases are filed.

In *Residential Capital*, Citibank argued that but for the debtor filing for bankruptcy protection, Citibank would have been entitled to collect interest at the contractually stated default rate. As support, Citibank cited *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.,* 549 U.S. 443 (2007) (holding that a creditor's rights in bankruptcy derive from the substantive law creating those rights, subject to qualifying or contrary provisions of the Bankruptcy Code.) Additionally, Citibank argued that the debtor could not overcome the rebuttable presumption that the

over-secured creditor [Citibank] was entitled to interest at the contractual default rate. The ResCap liquidating trust argued that *Travelers* was not controlling and that the imposition of the contractual default rate would harm unsecured creditors by taking money out of their pocket and redistributing it to Citibank.

The *Residential Capital* court followed *785 Partners* and noted that the rebuttable presumption embodied in section 506 is subject to certain equitable considerations including, among others: 1) did the over-secured creditor engage in misconduct, 2) will the recovery by unsecured creditors be reduced significantly reduced by such an award, 3) will the debtor's fresh start be impaired, 4) and will the imposition of the default rate constitute a penalty.

The court reviewed the equitable factors described above and determined that the only factor at issue "is the potential harm to unsecured creditors." *In re Residential Capital*, 508 B.R. at 857. The debtor argued that its insolvency – "meaning that unsecured creditors will be harmed by an award of the contract rate . . ." – allowed it to overcome the rebuttable presumption. *Id.* However, the court noted that there is no "bright line rule that the contract rate should be refused in all insolvent debtor cases." *Id. See In re Madison 92nd St. Assocs., LLC*, 472 B.R. 189, 188 (Bankr. S.D.N.Y. 2012) ("[m]ost chapter 11 cases involve insolvent debtors, and such an exception would swallow up the rule that the over-secured creditor is presumptively entitled to the contract rate." *Id.* at 200). Moreover, such a bright line rule refusing to enforce the default rate could increase the cost of credit "… if the creditor cannot protect itself from 'unforeseeable costs involved with collecting from debtors in default.'" *In re Terry* 27 F.3d at 243 (quoting *Residential Capital*, 508 B.R. at 858). While insolvency is an important factor, it is not the determinative factor. Ultimately, the court in *Residential Capital* determined that the equities favored awarding the over-secured creditor its contractual default interest rate. In reaching this decision, the court analyzed that impact on unsecured creditors and further determined that "[t]he reduction in distributable assets is not – on its own – sufficient to overcome the rebuttable presumption in favor of the contractual default rate." *Id* at 869.

The court specifically noted the following facts that weighed in favor of Citibank receiving interest at the default rate:

1) Citibank entered into 10 amendments with the debtor and its affiliates which had allowed the debtor to operate as a going concern in bankruptcy for the benefit of the unsecured and secured creditors. The approximate $4.5 million in interest that Citibank would be paid would only diminish the pool of assets to be distributed to unsecured creditors by approximately 0.2%.

2) Citibank could have demanded a higher non-default rate while negotiating the 10th amendment to the loan agreement if it thought it wouldn't later be awarded interest at the default rate. Thus, the potential adverse effect on future high-risk borrowers could be devastating.

Interestingly, the *Residential Capital* court did decline to award Citibank post-petition interest at the default rate for the sixteen (16) days between ResCap's May 14

petition date and the May 30 loan maturity date because the only event of default until maturity was the filing of the bankruptcy petition.[6]

After finding that Citibank was entitled to collect post-petition interest at the default rate, the court also awarded Citibank legal fees. The court further stated that Citibank would have been entitled to legal fees even if it hadn't been awarded interest at the default rate pursuant to the terms of the loan agreement and because Citibank pursued them in good faith.

The failure of Congress to provide in the Bankruptcy Code for the appropriate interest rate in section 506(b) circumstances will certainly continue to trigger disputes. Until then, the majority of courts will likely continue to applying the rebuttable presumption that the contract default rate applies subject to equitable considerations.

In *GE Capital Corp. v. Future Media Prods*., 536 F.3d 969 (9th Cir. 2008), as amended by 547 F.3d 956 (9th Cir. 2008), General Electric Capital Corporation ("GECC") appealed a bankruptcy court's order denying GECC's request for interest at the default rate. The bankruptcy court denied GECC's request for attorney's fees and costs on the grounds that GECC was not the prevailing party.

GECC, an over-secured creditor, agreed to loan money to Future Media under an agreement that called for a higher interest rate upon default. Additionally, the agreement obligated Future Media to pay attorneys' fees and costs in connection with any dispute. Future Media's repeated defaults led the company to file a chapter 11 bankruptcy petition and liquidate its assets. GECC subsequently received approximately $5.7 million from Future Media which included default interest and legal fees. However, the unsecured creditors committee successfully argued that GECC was not entitled to interest at the default rate and should not receive attorneys' fees and costs. GECC was ordered to return said funds and it filed the appeal.

The Ninth Circuit began its analysis by interpreting the Supreme Court's opinion in *Travelers Cas. & Sur. Co. of Am. V. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007) to mean that the "default rate should be enforced, subject only to the substantive law governing the loan agreement, unless a provision of the Bankruptcy Code provides otherwise." *Id.*

That same Ninth Circuit had previously held in *In re Entz-White Lumber and Supply, Inc.* 850 F.2d 1338 (9th Cir. 1988) that an over-secured creditor was not entitled to interest at the default rate where its claim was paid in full pursuant to the terms of a chapter 11 plan. In *Entz-White*, the court found such a "qualifying or contrary provision"

[6] The type of default and default language included in the contract can have an effect on whether default interest will be allowed. The court in *In re Payless Cashways, Inc.* 287 B.R. 482 (Bankr. W.D. Mol. 2002) held that the automatic stay prevented the creditor from declaring default via default notices where acceleration was not automatic and therefore, the creditor could not assert the contract default rate. Additionally, the courts in *In re IT Group, Inc.*, 302 B.R. 483 (D. Del. 2003) and *In re Bownetree*, 2009 WL 2226107 denied default interest where the debtor's only default is filing the bankruptcy petition. The courts held that *ipso facto* clauses were impermissible and cannot invoke the default rate alone.

of the Bankruptcy Code that barred the creditor's right to collect interest at the default rate. Specifically, the court found that because the Bankruptcy Code allows a chapter 11 debtor to cure a prior default and render the claim unimpaired, the debtor was permitted to nullify all consequences of default, including the implementation of a higher default rate.

In *Future Media*, the Ninth Circuit found no "qualifying or contrary provision" of the Bankruptcy Code in the context of an asset sale to bar the recovery of default interest. Therefore, outside the context of a plan of reorganization, "bankruptcy court should apply a presumption of allowability for the contracted for default rate, 'provided that the rate is not unenforceable under applicable non-bankruptcy law.'" 4 *Collier on Bankruptcy*, P 506.04[2][b][ii] (15th Ed. 1996) (quoting *Future Media* 536 F.3d at 974). Therefore, Ninth Circuit determined that the lower court incorrectly extended *Entz-White's* rule outside the context of a chapter 11 plan. Also, see *In re Lapiana*, 909 F.2d 221, 223 (7th Cir. 1990) holding… "[B]ankruptcy, despite its equity pedigree, is a procedure for enforcing pre-bankruptcy entitlements under specified terms and conditions rather than a flight of redistributive fancy . . .".

Future Media and *Travelers* reflect the courts growing deference to non-bankruptcy law where the Bankruptcy Code does not provide a "qualifying or contrary provision."

c. Late Fees

While the court in *785 Partners* determined that interest at the default rate was permissible, the court refused to permit the over-secured creditor to collect the late payment premium for two main reasons.

The court began its analysis by pointing out that a late payment premium is designed to cover administrative expenses associated with processing late payments. However, … "the [d]ebtor will never make a late payment of an amount due under the [l]oan [d]ocuments, and the [over-secured creditor] will not, therefore, incur the additional costs of handling such a late payment." *785 Partners*, 470 B.R. at 136-137. Upon confirmation of a plan, all obligations and rights of the parties are extinguished and replaced by the confirmed plan. Therefore, all subsequent payments made by the debtor to the over-secured creditor will be under the confirmed plan and a new note. Accordingly, the late payment charge will never became due and will never be earned.

Secondly, the over-secured creditor is limited to recovering "reasonable" fees provided for in the loan agreement. *United States v. Ron Pair Enterprises, Inc.* 489 U.S. 235, 241 (1989). Case law is ". . . uniform that over-secured creditors may receive payment of either default interest or late charges, but not both." *In re Vest Assocs.*, 217 B.R. 696, 701 (Bankr. S.D.N.Y 1998) *accord In re Dixon*, 228 B.R. 166, 177 (W.D. Va. 1998); *In re Market Center East Retail Property, Inc.*, 433 B.R. 335, 365 (Bankr. D.N.M. 2010); *In re Cliftondale Oaks, LLC*, 357 B.R. 883, 887 (Bankr. N.D. Ga. 2006); *In re Route One West Windsor Ltd. P'ship,* 225 B.R. 76, 92 (Bankr. D.N.J. 1998); *In re 1095 Commonwealth Ave. Corp.*, 204 B.R. 284, 305 (Bankr. D. Mass. 1997); *In re Kalian*, 178 B.R. 308, 312 n. 9 (Bankr. D.R.I. 1995) (citing cases). "The reason is that the late fee and default interest are designed to compensate the lender for the same injury, and awarding both amounts to double recovery." *Cliftondale Oaks*, 357 B.R. at 887.

In theory however, if the late fee is a bargained-for exchange between sophisticated parties, the logical argument follows that such a late fee should be treated no differently than a claim for default interest.

d. Reimbursement of Attorneys' Fees

The part of § 502 that comes into play regarding allowance of fees and other charges is § 502(b)(1). As shown above, this section disallows any claim that is unenforceable against the debtor and the property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured. Under this section, the objecting party carries the burden of proving that claims are unenforceable under any agreement or applicable law. *In re Harford Sands Inc*., 372 F.3d 637, 640 (4th Cir. 2004) (citing Fed. R. Bankr. P. 9017, Fed. R. Evid. 301*)*.

Section 502(b) disallows unmatured interest (11 U.S.C.S. § 502(b)(2)); it does not specifically disallow attorneys' fees of creditors or certain other charges. The Bankruptcy Code does not bar an unsecured claim for post-petition attorneys' fees authorized by a *prepetition contract valid under state law*. See *Travelers Cas. and Sur. Co. of America v. Pacific Gas and Elec. Co.,* 549 U.S. 443, 450 - 51, 127 S. Ct. 1199, 167 L. Ed. 2d 178 (2007). The *Travelers* decision further supports that that a claim for post-petition fees must be allowed under § 502(b) unless it is unenforceable within the meaning of § 502(b)(1). Further, the United States Court of Appeals for the Second Circuit makes it clear that § 502(b) imposes no bar to an *unsecured creditor's* ability to recover post-petition attorneys' fees as a contingent right. *Ogle v. Fid. & Deposit Co. of Md*., 586 F.3d 143, 147 (2d Cir. 2009) (stating the holding in *United Merchs. & Mfrs., Inv. v. Equitable Life Assurance Soc'y of the U.S.*, 674 F.2d 134 (2d Cir. 1982). Later the right of unsecured or undersecured creditors to recover Attorneys' Fees will be discussed in more detail.

Section 506(a) of the Bankruptcy Code defines a secured claim as one secured by a lien on property in which the debtor's estate has an interest, or that is subject to setoff under § 553 of the Bankruptcy Code. Pursuant to § 506(b) of the Bankruptcy Code, a secured claim is considered "oversecured" if the value of the collateral securing the creditor's claim exceeds the amount of the creditor's claim. The amount of the creditor's claim is customarily determined as of the date on which a debtor's bankruptcy case is filed and includes the principal amount of the obligation plus all matured prepetition interest, fees, costs and charges owing as of the petition date. Accordingly, if a creditor holds a lien on a debtor's plant and equipment to secure a loan in the amount of $20 million and the value of the plant and equipment is $25 million, the creditor's secured claim is "oversecured" by $5 million.

Section 506(b), which applies to oversecured creditors, provides, in relevant part, that for "an allowed secured claim . . . there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose." As such, a secured creditor is entitled to add attorneys' fees to its secured claim if the following conditions are met: (1) the creditor is oversecured; (2) the fees are reasonable; and (3) the fees are provided for in the agreement or state statute under which the claim arose. *See In re Amron Techs., Inc*., 376 B.R. 49, 54 (Bankr. M.D. Ga. 2007).

The language and structure of 11 U.S.C.S. § 502 and § 506 demonstrate that the two sections should be read in tandem with one another, for they address complementary but different questions. Section 502 deals with the threshold question of whether a claim should be allowed or disallowed. Once the bankruptcy court determines that a claim is allowable, § 506 deals with the entirely different, more narrow question of whether certain types of claims should be considered secured or unsecured. Applying this interpretation to a creditor's claim for contractually set attorneys' fees, the threshold question is whether the claim for attorney's fees is allowed under § 502. The entire claim to fees is allowable under § 502 as long as the exceptions in subsection (b) do not apply. If none of these exceptions apply, the fees claim is allowed and the fees must then be assessed for reasonableness under 11 U.S.C.S. § 506(b). *Welzel v. Advocate Realty Invs., L.L.C. (In re Welzel*), 275 F.3d 1308 (11th Cir. 2001)

Interestingly, the in *Welzel* decision the Eleventh Circuit adopted the bifurcation approach to determine the extent to which an oversecured creditor's fully vested contractually liquidated attorneys' fees were entitled to secured status under 11 U.S.C. § 506(b). *Id. at 1314-20.* The Weizel court's description of this "bifurcation approach" is clear and broadly stated:

Once the bankruptcy court determines that the fees are allowed under § 502, it should then analyze their reasonableness under § 506(b). Fees deemed reasonable constitute a secured claim, with the balance of unreasonable fees treated as an unsecured claim. *Id.* at 1320. Since the language of § 506(b) "refers blanketly to 'reasonable fees,' without differentiation based on the time the fees vested," Welzel held that even attorneys' fees that have fully vested prepetition may be bifurcated in bankruptcy into those amounts which are reasonable and those amounts which are not. *Id.* at 1314.

i. Necessity of Agreement or State Statute - Allowance of Claim for Attorneys' Fees

State law governing the right to attorneys' fees should be considered first. A good example of this is *Southside, LLC v. Suntrust Bank (In re Southside, LLC*), 520 B.R. 914 (N.D. Ga. 2014). Under Georgia law, a prerequisite to collecting attorneys' fees is written notice of an intent to enforce an attorneys' fee provision, providing the party sought to be held liable ten days to pay the debt in full to avoid the attorneys' fees. O.C.G.A. § 13-1-11(a). A bank that filed a claim against an LLC's chapter 11 bankruptcy estate, seeking payment of principal and interest it was owed on a debt the LLC guaranteed, was not allowed to recover attorneys' fees it incurred pre-petition to collect the debt because it did not give the LLC notice under O.C.G.A. § 13-1-11 that the debt was in default and that it would be pursuing collection action. Although the bank's claim seeking payment of pre-petition attorneys' fees was disallowed under 11 U.S.C.S. § 502 because it could not be collected under state law, the bank was allowed under 11 U.S.C.S. § 506(b) to recover attorneys' fees and costs it incurred postpetition to collect the debt because the debt was oversecured. Key to this ruling was language in the Security Deed that provided for attorneys' fees incurred in bankruptcy proceedings.

Careful drafting of both original loan documents and modifications to those documents will avoid issues with the right to attorney's fees. In *In re Monticello Realty*

Invs., LLC, 526 B. R. 902 (MD Fla. 2015)*,* The parties' dispute primarily revolves around a bank's claim of $118,377.22 in post-petition attorney's fees. The debtor argued that the bank was not entitled to post-petition attorney's fees because, while the Note contained a specific provision for the recovery of the Bank's attorney's fees in the event of a bankruptcy, the modification agreement in 2013 did not contain such a provision. However, the modification did contain a provision that stated that nothing contained in the modification agreement constituted a waiver of any of the rights of the bank under the terms of the Loan Documents. Another provision provided that the terms of the Loan Documents shall remain valid and in full force and effect except as may be herein modified and amended The Court found that the bank did not waive its right to recover attorney's fees in the bankruptcy case.

A bankruptcy court allowed fees under Section 506(b) to an oversecured lender that defended a trustee's preference and fraudulent conveyance claims. I*In re Mac-Go Corp*., 215 Bankr. LEXIS 904 (ND Cal.). Creditor bank's requested fees, § 506(b), fell within the fee clauses in the loan documents because the loan agreement's fee clause was not limited to the party who "brings" an action. As such, it also applied to the party who successfully defended an action by raising the enforceable terms of the litigants' binding contract. Accordingly, the bank was entitled to recover the reasonable fees and costs that it incurred defending against the fraudulent conveyance claims for relief. The bank was also entitled to recover the fees in incurred in defending against the Trustee's preference claims for relief and in successfully litigating the Trustee's 11 U.S.C.S. § 549 claims.

ii. The Reasonableness Standard for Attorneys' Fees under Section 506(b)

There are many cases which address the reasonableness of fees and expenses allowable to oversecured creditors who have collateral that is retained by the debtor or perhaps sold by the debtor. Some of the recent key cases that discuss reasonableness are:

In re Monticello Realty Invs., LLC, 526 B. R. 902 (M.D. Florida 2015)

In making a fee determination, the Court must consider not only the fee agreement but the overall fairness and reasonableness of the fee under all of the circumstances. Reasonable fees are those necessary to the collection and protection of a creditor's claim and include fees for those actions which a similarly situated creditor might have taken. The fees must be cost justified by the economics of the situation and necessary to preserve the creditor's interest in light of the legal issues involved. A secured creditor is not entitled to compensation for its attorney's fees for every action it takes by claiming that its rights have been effected." *Id.* at 912-913.

In re Gregg, 528 B.R. 645 (D.S.C. 2014)

> Although 11 U.S.C.S. § 506(b) provides for an oversecured creditor to recover attorney fees, it is not a guarantee. The bankruptcy court has the responsibility of preventing overreaching by attorneys. If an attorney's services are not reasonably necessary, or where action is taken because of an attorney's excessive caution or overzealous advocacy, the court has the obligation to disallow the fees…. [A] court should consider factors such as (1) whether the time spent was appropriate to the complexity of the task, and (2) whether the fee should be adjusted to reflect

the court's observation of the nature of the case and manner of its administration. The court's underlying consideration should focus on whether the economics of the situation, in light of the creditor's interest, justified the attorney's actions. *Id.* at 654 (citations omitted).

In re Shree Mahalaxmi, Inc., 522 B.R. 899 (W.D. Tex. 2014)

The reasonableness of postpetition attorneys' fees are tested under federal law. In the Fifth Circuit, a three-step approach is used to determine the reasonableness of attorneys' fees for oversecured creditors: (1) determine the nature and extent of the services supplied by the attorney with reference to the time and labor records submitted; (2) ascertain the value of the services; and (3) briefly explain the findings and the reasons upon which the award is based. Additionally, a court reviewing the reasonableness of a secured creditor's fees should consider the twelve factors the United States Court of Appeals for the Fifth Circuit set out *in Johnson v. Georgia Highway Exp., Inc*., the circumstances surrounding the case, the manner of its administration, and whether duplication of services occurred *Id.* at 907.

iii. The Broad Reach of the Bankruptcy Court's Power to Determine Reasonableness of Fees under Section 506(b)

Most bankruptcy attorneys would expect that a review by the Bankruptcy Court of the reasonableness of fees would not occur after relief from stay is granted or collateral is abandoned to a secured creditor. Most often, relief from stay or abandonment would not occur if there is equity, but on some occasions it does happen, as discussed in the following two cases.

In Wells Fargo Bank, N.A. v. 804 Congress, No. 12-50382,
2014 WL 2816521 (5th Cir. June 23, 2014)

In the case of *In Wells Fargo Bank, N.A. v. 804 Congress*, No. 12-50382, 2014 WL 2816521 (5th Cir. June 23, 2014), the Fifth Circuit affirmed that the § 506(b) reasonableness standard applies to an oversecured lender's legal fees in a non-judicial foreclosure sale.[7] Further, because the lender did not substantiate these fees, the Fifth Circuit found they were unreasonable and therefore not allowable as a secured claim, but remanded the case to the bankruptcy court to determine whether they could be treated as an unsecured claim under § 502 of the Bankruptcy Code.

Wells Fargo Bank, N.A. ("Wells Fargo") financed the purchase of a building by 804 Congress, LLC, the Debtor. In return, Wells Fargo received a Note which was secured by a Deed of Trust Security Agreement granting Wells Fargo a first-priority lien on the property. The Note entitled Wells Fargo to receive all reasonable attorneys' fees and collection fees following a default.

In response to a scheduled foreclosure sale by Wells Fargo, the Debtor filed for chapter 11 bankruptcy. The bankruptcy court lifted the automatic stay to enable Wells Fargo to conduct a non-judicial foreclosure sale in accordance with applicable state law.

[7] This summary obtained from Practical Law, July 14, 2014

The foreclosure sale was conducted in accordance with the Deed of Trust, and yielded about $4.355 million.

The bankruptcy court exercised jurisdiction over the entire proceeds of the foreclosure sale. Wells Fargo and the trustee for the Deed of Trust ("Trustee") each filed claims for the amount they were owed under the Deed of Trust. The bankruptcy court directed the Trustee to pay Wells Fargo in full except for its attorneys' fees which it completely disallowed because Wells Fargo had not "filed a proper application for fees" and did not provide "supporting documentation or testimony that the fees were reasonable."

Wells Fargo appealed to the district court which reversed the holding of the bankruptcy court and remanded for further proceedings. The district court held that the bankruptcy court ceased to have jurisdiction over the property and sale proceeds when it lifted the automatic stay and the foreclosure sale occurred. The district court held that the distribution of the sale proceeds should be governed by Texas law rather than federal bankruptcy law. The Debtor appealed to the Fifth Circuit.

The Fifth Circuit reviewed the findings and held that the bankruptcy court had not erred in disallowing Wells Fargo's legal fees under § 506(b). Section 506(b) of the Bankruptcy Code entitles an oversecured creditor to a claim for postpetition interest and any reasonable fees, costs or charges provided for in the agreement under which the claim arose. The Court did not interpret § 506(b) to apply only when a sale occurs by the trustee in a bankruptcy under § 363 of the Bankruptcy Code.

The Fifth Circuit held that:

- Section 506(b) governs distributions to oversecured creditors regardless of state law.

- Lifting the automatic stay to allow Wells Fargo to foreclose did not give the Trustee any further authority and did not insulate the Debtor or any creditor from the reach of § 506(b). It stated that "lifting the automatic stay to allow Wells Fargo to foreclose was not tantamount to an abandonment of property."

The Fifth Circuit held that the bankruptcy court did not abuse its discretion in finding that Wells Fargo failed to prove reasonable attorneys' fees. Although Wells Fargo provided evidence that it had paid its attorneys the amount requested, the bankruptcy court was within its discretion in finding that there was no documentation of the time that was spent and no testimony as to what was a reasonable fee. Therefore, the Fifth Circuit held that the bankruptcy court did not err in finding under § 506(b) that the amount of attorneys' fees sought was not substantiated, and therefore, not reasonable. The Fifth Circuit also noted that even if Texas law governed the issue, the fees would still be subject to a reasonableness requirement.

Wells Fargo and the Trustee asserted that even if the attorneys' fees are not granted under § 506(b), they should still be recoverable as an unsecured claim under § 502 of the Bankruptcy Code. While the Court noted that other circuits have allowed fees deemed unreasonable to be treated as an unsecured claim, it left this question for the

bankruptcy court to decide because Wells Fargo and the Trustee had not fully briefed the issue and it was unclear whether they raised it in the bankruptcy court.

When involved in a bankruptcy case, counsel for oversecured lenders should always document their fees and expenses in a manner that will permit them to file fee applications with the requisite detail to support an argument that the fees and costs are reasonable, and therefore recoverable, under § 506(b). In addition, oversecured lenders should also try to get a provision in stay orders that stay that the foreclosure and distribution of proceeds will be governed exclusively by applicable state law.

In Re Ormond, 215 Bankr. Lexis 653 (EDNC 2015)

While the Court in *804 Congress*, determined that it had the power to determine reasonableness because the collateral had not been abandoned, the United States Bankruptcy Court for the Eastern District of North Carolina found in a March 2015 decision that it could determine reasonableness of fees after abandonment. In *In Re Ormond*, 215 Bankr. Lexis 653 (EDNC 2015), the court held that it had jurisdiction to address objections to the bank's claim for attorneys' fees associated with sale of abandoned property because, while the property ceased to be property of the estate, it was still property of the debtor over which the court had exclusive jurisdiction pursuant to 28 U.S.C.S. § 1334(e)(1). The Court determined that it also had jurisdiction over claim objection because the determination of the objection would affect other creditors in the case, especially the second lien holder and unsecured claimants. The fee award sought by bank, which represented the maximum amount of attorney's fees available under North Carolina law of 15 percent of the final sale price pursuant to N.C. Gen. Stat. § 6-21.2 and the maximum state law trustee commission of five percent, could not be approved without more information for the court to determine whether the requested amount was reasonable.

Under North Carolina law, if an agreement for payment of Attorneys' Fees provides that the fees are based on a specific percentage of the outstanding balance of the obligation, then N.C.G.S § 6-21.2(1) authorizes the application of the parties' contractually agreed upon percentage. If, however, the fee agreement only calls for payment of "reasonable attorneys' fees" rather than a specific percentage, § 6-21.2(2) applies, which provides that "reasonable" is construed to mean fifteen percent of the outstanding balance. A third type of fee agreement might contain a method for calculating fees but do not specify any percentage.

On February 25, 2014, Yadkin Bank filed a motion for relief from the automatic stay as to the Property and CPS objected. After notice and a hearing, on May 27, 2014, the court granted Yadkin Bank's motion for relief from the automatic stay. On July 7, 2014, the trustee filed a motion to abandon real estate, including the property, based on the lack of equity and the possibility of adverse tax consequences from the foreclosure sale. On July 29, 2014, the court granted the trustee's motion for abandonment pursuant to 11 U.S.C. § 554(a) finding that certain real estate, including the property, was "burdensome and of no benefit to the bankruptcy estate." *Id.* At *3.

Yadkin Bank proceeded with its repossession and foreclosure sale of the property through a special proceeding before the Clerk of Superior Court of Beaufort County,

North Carolina After several upset bids the sale was completed with the last and final bid being $983,981.25.

The proof of claim filed by Yadkin Bank was paid from the proceeds of the foreclosure sale in the approximate amount of $739,718.88. This amount is accounted for as follows: principal balance of $620,314.14; accrued interest of $116,054.74; and appraisal fee of $3,350.00. A balance of $244,262.37 remained in the attorney for Yadkin Bank's trust account.

From this amount, Yadkin Bank sought reimbursement for attorney's fees for the foreclosure sale in the amount of fifteen percent of the payoff pursuant to N.C. Gen. Stat. § 6-21.1 of approximately $110,957.82, in addition to the 5% statutory foreclosing trustee commission of approximately $49,199.06. After deducting these amounts, the sum of $84,105.49 would remain for payment towards a second lien on the property.

At a hearing before the court, Yadkin Bank has not filed an application for attorney's fees with the Court. The trustee does not contest that Yadkin Bank is entitled to reasonable attorney's fees in the collection and subsequent foreclosure of the property pursuant to the contract and state law, but maintains that in order to receive a fee, it must comply with the requirements of 11 U.S.C. § 506(b) and move for an order from the Court setting a proper legal fee.

Yadkin Bank contended that the order of abandonment entered on July 7, 2014, divested the Court of any jurisdiction regarding the property, or its proceed, and also asserted that that the Court determined that it did have jurisdiction, the fifteen percent attorney's fees calculation was per se reasonable under North Carolina law.

The Court determined that it had jurisdiction over the property because even though it was no longer property of the estate, it was still property of the debtors. Section 1334 of Title 28 of the United States Code confers original and exclusive jurisdiction over a bankruptcy case to a federal court sitting as a bankruptcy court. Section 1334(e)(1) provides that the court in which a case under title 11 is commenced or is pending shall have exclusive jurisdiction "of all the property, wherever located, *of the debtor as of the commencement of such case*, and any property of the estate." 28 U.S.C. § 1334(e)(1) (emphasis added). See *In re Gunter*, 410 B.R. 178, 181 (Bankr. E.D.N.C. 2008) (finding jurisdiction over property of the debtor after the property was abandoned); 11 U.S.C. § 554.

The promissory note executed by the debtors and Yadkin Bank provided the following provision regarding attorney's fees:

> Attorneys' Fees and Other Costs. If legal proceedings are instituted to enforce the terms of this Note, Borrower agrees to pay all costs of the Lender in connection therewith, including reasonable attorneys' fees to the extent permitted by law.

Because the agreement called for "reasonable attorneys' fees to the extent permitted by law." the provisions of § 6-21.2(2), rather than § 6-21.2(1) applied. Based on recent cases, the court found that strict application of the per se fifteen percent calculation was not proper and it should apply the "lodestar" factors to determine if the attorney's fees sought were reasonable. Yadkin Bank was required to submit an affidavit

setting forth its time and billing records associated with its fees and costs related to the foreclosure.

Ultimately the Trustee and Yadkin Bank agreed on a $100,000 attorney fee and trustee commission, and the Bankruptcy Court approved this settlement.

iv. Bifurcation of Attorneys' Fees Claims

In re Coastal Realty Investments, Inc., 214 Bankr. LEXIS 918 (Bankr. SD Ga. 2014), deals with the entirely different, more narrow question of whether certain types of claims should be considered secured or unsecured. This recent decision from the United States Bankruptcy Court for the Southern District of Georgia, outlines the Eleventh Circuit's method for determining whether an oversecured creditor's fully vested contractually liquidated attorneys' fees are entitled to secured status under section 506(b) of the Bankruptcy Code. The court adhered to the bifurcation approach adopted by the Eleventh Circuit which requires that, as a threshold matter, the court must first determine whether a claim for attorneys' fees is allowed under section 502 of the Bankruptcy Code. Then the court must proceed with a "reasonableness" analysis pursuant to section 506(b). An oversecured creditor's allowed claim for attorneys' fees is bifurcated based on its reasonableness or lack thereof. Reasonable fees are entitled to secured status, and any remaining fees are treated as a general unsecured claim.

Bank of the Ozarks was the primary secured creditor in the single asset real estate case of Coastal Realty Investments, Inc. The debtor purchased a large condominium complex, which secured approximately $1,148,000 in debt owed to Ozarks. Ozarks was oversecured by approximately $227,000, as the court determined the complex to be worth $1,375,000. Pursuant to section 506(b) of the Bankruptcy Code, Ozarks submitted an application to recover approximately $88,000 in postpetition interest along with attorneys' fees contractually liquidated at 15% of the principal and interest owing – an amount totaling approximately $179,000. In actuality, Ozarks only incurred around $102,000 in attorneys' fees in connection with collection of the debt.

Ozarks' claim to attorneys' fees arose under a series of loan documents executed in connection with the financing secured by the condominium complex. The debtor issued a promissory note in favor of Ozarks' predecessor in interest for approximately $1,333,000. With respect to attorneys' fees, the note provided as follows: "I also agree to pay attorney's fees of 15 percent of the principal and interest then owed, plus court costs . . . I also agree to pay the reasonable attorney's fees and costs [incurred] to collect this debt as awarded by any court exercising jurisdiction under the Bankruptcy Code."

The debtor defaulted on the note when it failed to make its periodic payments, and the note was accelerated. After Ozark filed suit, the debtor filed a voluntary petition for chapter 11 protection in May, 2011.

In response to Ozarks' application for expenses, the debtor contested (1) the applicable accrual method of the contract interest rate; (2) the allowance of attorneys' fees pursuant to section 13-1-11 of the Georgia Code and § 502(b)(1) of the Bankruptcy Code; and (3) the reasonableness of the attorneys' fees under § 506(b) of the Bankruptcy Code.

In this case, the parties agreed that Ozarks was oversecured and that the loan documents provided for attorneys' fees. The debtor, however, disputed the amount of attorneys' fees included within the scope of the loan documents and the extent to which any allowed fees were entitled to secured status. The debtor argued that the majority of Ozarks' claim should be disallowed under § 502(b)(1) because the loan documents were ambiguous on the issue of attorneys' fees. Additionally, the debtor asserted that the contractually liquidated attorneys' fees were unreasonable under §506(b) and, therefore, Ozarks' secured claim for reasonable fees should not exceed the postpetition amount incurred by the debtor's counsel.

Bound by the Eleventh Circuit's decision in *Welzel v. Advocate Realty Investments, LLC (In re Weizel)*, 275 F.3d 1308 (11th Cir. 2001, the court first determined whether Ozarks' claim was allowed under § 502(b)(1) of the Bankruptcy Code. Under Georgia law, when a note specifically provides for liquidated attorneys' fees calculated at a fixed percentage of the debt, such fees are enforceable up to but not in excess of 15% of the principal and interest owing on the note. Although the loan documents clearly provided for attorneys' fees, the debtor argued that the documents were inconsistent and ambiguous regarding the method by which the fees were to be calculated. The debtor requested that the court construe the ambiguous terms against Ozarks to invalidate the 15% provisions and limit the claim to "reasonable attorneys' fees." According to the debtor, "reasonable attorneys' fees" should not exceed the attorneys' fees incurred by the debtor during the same period.

The court, however, rejected the debtor's arguments, finding that the other loan documents had incorporated the terms of the promissory note by reference. Moreover, the court held that the debtor's argument mistakenly applied the § 506(b) reasonableness standard to the issue of claims allowance under § 502. As discussed in this manuscript, § 506(b) is not a disallowance provision, but rather provides the basis for determining whether a nonbankruptcy law created obligation is allowable as part of a secured or unsecured claim in a bankruptcy case. After a lengthy discussion of allowance, the court proceeded with the *Welzel* approach to determine the extent to which Ozarks' allowed claim for approximately $179,000 was reasonable and, therefore, entitled to secured status.

The Eleventh Circuit applies the "lodestar analysis" to determine the reasonableness of an oversecured creditor's attorneys' fees. The only issue with respect to reasonableness was the amount of time billed by Ozarks' attorney. From November 2011 to August 2013, Ozarks' counsel billed 404 hours in connection with the collection of the debt. The court held a reasonableness hearing at which Ozarks' expert witness testified to the reasonableness of the time expended. The debtor did not present competing testimony, but simply argued that the hours deemed reasonable should not exceed the hours the debtor's counsel billed during the same period. Again, the court found this argument unpersuasive.

The court found that Ozarks' allowed claim of approximately $179,000 was not entirely reasonable. Implicit in the lodestar analysis is the requirement that reasonable attorneys' fees be actually incurred. Ozarks actually incurred only $102,485.70 in attorneys' fees. Its claim for approximately $179,000 was based on the 15% provision contained in the promissory note. Consequently, the court held that only $102,485.70 of

Ozarks' claim constituted reasonable attorneys' fees that could be added to its secured claim. The approximately $76,000 difference, therefore, was required to be treated as a general unsecured claim.

Not all courts follow the Eighth Circuit approach to allow undersecured creditors an unsecured claim for fees. In *In re Croatan Surf Club, LLC*, 2012 Bankr. LEXIS 2369, *19-22 (Bankr. E.D.N.C. May 25, 2012), Judge Humrickhouse determined that the difference between the value of the collateral, $19,148,655, and the claim amount of the lender, $18,008,563, was $1,140,092, and this difference constituted the amount the lender was is eligible to "add on" to its claim under § 506(b). Post-petition interest had already accrued in an amount greater than the available equity in the collateral. The remainder of the accrued post-petition interest to date was disallowed. The court found that it did not need to address allowance of post-petition attorneys' fees as an add-on to the secured claim because no collateral remains to secure such fees, and therefore the lender was is not eligible for post-petition attorneys' fees under § 506(b). The court found that no unsecured claim is created for the post-petition fees sought; rather, the fees are disallowed. Quoting the court, "Section 506(b) provides a limited substantive right to post-petition fees. If such fees are not allowed under that section, they do not morph into an allowable unsecured claim, since there is no section of the Code other than 506(b), that permits allowance of post-petition fees." *Id.* at *21. Interestingly, two other judges in the Eastern District of North Carolina do allow Attorneys' Fees to unsecured creditors. See *In re F & G Leonard, LLC*, 2011 Bankr. LEXIS 4518, *1 (Bankr. E.D.N.C. Oct. 21, 2011); *In re Holden*, 491 B.R.728 (EDNC March 3, 2015)

v. Requirement of an Agreement providing for Fees: What if the Oversecured Lender has a Confession of Judgment?

In *McCormick v. McCormick (In re McCormick*), 523 B.R. 151 (8th Circ. BAP, 2014) the bankruptcy court examined the whether fees and costs were allowed under an agreement under which the claim arose. It found that the lender held a judicial lien that arose from a confession of judgment given by the debtor pre-petition. The confession of judgment was triggered upon a default by the debtor under a forbearance agreement that addressed defaults under various loan documents. The loan documents contained an attorney fee provision.

The bankruptcy court noted that the lender's judicial liens 'arose' under the judgments when they were recorded by the clerk under North Dakota. N.D.C.C. §28-20-13. Relying upon a North Dakota statute that disfavors payment of attorney fees, the bankruptcy court concluded that the absence of "a clause or sentence in the judgment entitling the lender to collect attorney fees" was fatal to the lender's request for payment. Accordingly, the lender's motion to compel payment was denied, and the Debtor's motion disallowing the fees was granted.

The lender appealed contending that the underlying loan documents, the forbearance agreement and terms of the confirmed Plan should be considered collectively to constitute the agreement required by § 506(b). The Eighth Circuit BAP found that the bankruptcy court's reliance upon the judgments as the "agreement" under which lender's right to payment of its fees arises was misplaced. The notes and forbearance agreement related to the loans contained appropriate attorney fee provisions. Those were the

instruments under which the lender's "claim arose." The judgment was simply a means of enforcing a right to payment. Here, the judgments happened to give the lender a lien on real property of the judgment debtors in the counties where the judgment was entered, which increased the collateral for the lender's claim but did not change the instruments under which the right to claim attorney fees arose.

In *In re: Full of Faith Ministries, Inc*., 2014 Bankr. LEXIS 610 (MD Fla.), Judge Glenn determined that a homeowner association that had obtained a judgment against a debtor was entitled to interest, attorneys' fees, and costs on its claim under § 506(b) of the Bankruptcy Code. The chapter 7 trustee recovered property that the debtor has transferred fraudulently. The court found that title to the transferred property remained with the debtor at the time that the judgment was entered, and that the homeowner association's recordation of the Judgment created a lien on the property under §55.10 of the Florida Statutes. See *In re Veterans Choice Mortgage*, 291 B.R. 894, 897-98 (Bankr. S.D. Ga. 2003) (The Court found that a creditor's claim was secured by property recovered in a fraudulent transfer action, where the creditor was "a creditor at the time of the fraudulent transfer and thereafter reduce[d] his claim to a judgment lien."); and *In re Romano*, 51 B.R. at 815 (The creditor's claim was secured even though it recorded its judgment after the debtor had transferred certain real property, since the court had determined that the transfer was fraudulent.).

vi. Exercise Caution When Taking an Assignment of Loan Documents – Protect the Right to Attorneys' Fees.

In the case *In re Gregg*, 528 B.R. 645 (D.S.C. 2014), the facts reflect that the Debtor borrowed $8,200,000.00 from NBSC secured by real property in South Carolina. The loan documents provided NBSC with the right to reimbursement for reasonable attorney fees and costs associated with default and collection. The original lender assigned the loan documents to a purchaser called Jupiter Capital and the assignment documents stated that NBSC transferred:

> all rights, titles and interests in and to the Loan and the Loan Documents, including all sums payable pursuant to the Loan or Loan documents and such other rights, titles, interests, privileges, claims, demands and equities in connection therewith, The sale document further states that the "total amount owed on the Note as of September 10, 2012 is Principal - $8,200,000, Interest - $167,416.53, Late Charge $1,000.

The chapter 11 trustee in the case objected to payment of any attorneys' fees to Jupiter Capital for legal fees incurred by NBSC and the Court allowed the objection. The court noted that generally, when a negotiable note is transferred it provides the transferee with the right to enforce the note and includes all rights of the transferor at the time of the transfer. 3 S.C. Code Ann. § 36-3-203(b). However, a party may transfer a note partially, conditionally, or with a reservation of rights. *See, e.g. Williston on Contracts* § 74:73, *Richard Lord (4th ed.)* (discussing the power to enforce a partially assigned debt).

Jupiter Capital and NBSC signed a sales contract. That sales contract identified their respective rights and by specification of certain rights and omission of others did not include NBSC's right to recover the fees. Jupiter Capital presented no case law that would require the Court to ignore the plain language of the contract in favor of the statutory

default. Thus, it is best if the assignment documents do not refer at all to the amount due on the loan or if they do, make sure ALL charges are specified.

PRACTICE POINTER: If parties taking an assignment of loan documents want to preserve their right to file a claim for fees under the loan documents, they should obtain copies of the fee invoices from the selling lender. If they need to file a proof of claim or application for fees under § 506(b) it may be very difficult to get copies of the invoices later. The selling lender will have little incentive to assist the buyer of the loan. Counsel for the selling lender will likely want to be paid for its efforts to assist the buyer party collect fees and expenses.

IV. The Intercreditor Agreement: The View From Bankruptcy

a. What Is An Intercreditor Agreement?

It is an agreement among two or more lenders that sets out the rights and obligations of the lenders with respect to a common borrower.

i. Intercreditor Agreements in 1st Lien/2nd Lien Structures

In this traditional structure for financing, there are two separate groups of lenders, each with their own collateral agent. Each group of lenders negotiates and documents with the borrower a set of credit documents that governs the terms upon which that group of lenders will extend credit to the borrower. The covenants may be different under the two sets of documents; second lien covenants will be no more restrictive than the first lien covenants. Each set of credit documents grants a separate lien on a common pool of collateral to secure the obligations of the borrower to each group of lenders.

The 1st lien and 2nd lien lenders separately negotiate and enter into an intercreditor agreement whereby the lenders agree, among other things, that the 1st lien lenders will be senior in priority with respect to the collateral pool (such that they will be paid first from proceeds of collateral) and that the 1st lien lenders will generally control rights with respect to the enforcement of remedies against the borrower. This is commonly referred to as **lien subordination**. The intercreditor agreement typically has additional provisions regarding the rights of the lenders to amend their credit documents and participate in a bankruptcy by the borrower. The 2nd lien debt is not subordinated in right of payment to the 1st lien debt.

ii. Intercreditor Agreements in Subordinated Debt Financing Structures

In a typical subordinated debt structure, there are two separate groups of lenders. Each group negotiates and documents with the borrower a set of credit documents that govern the terms upon which such group will extend credit to the borrower. The covenants may be different under the two sets of documents; the subordinated debt will be no more restrictive than the senior debt covenants. Typically, the subordinated debt is extended on an unsecured basis without a lien on the collateral.

The senior and subordinated lenders negotiate and enter into an intercreditor agreement whereby the subordinated debt is contractually subordinated in right of payment to the senior debt. The subordinated lenders agree to restrictions on payment of their subordinated debt in certain circumstances until the senior lenders are paid in full

and they also agree to turn over any payments received by them to the senior lender. This is referred to as **payment subordination**. The subordinated lenders also typically agree to a remedy standstill period during which subordinated lenders will not exercise any remedies. The intercreditor agreement for subordinated debt typically does not include provisions restricting the rights of the subordinated creditor in the bankruptcy case.

b. What Terms Are Set Forth In the Intercreditor Agreement?

Common terms addressed in the intercreditor agreement include:

1. What constitutes priority and subordinate obligations subject to the intercreditor agreement;
2. Relative priority of liens;
3. Who can receive payments from Borrower and when;
4. Recognition and agreement not to contest claims and liens of lenders;
5. Restrictions on modification of lenders' agreements;
6. Who can exercise remedies and when;
7. Buyout rights in favor of one or both groups of lenders; and
8. Waiver of various bankruptcy rights.

Terms of the Intercreditor Agreement vary widely depending on the size, complexity and nature of the transaction as well as the relative bargaining position as among the creditors to the agreement. In 2010, the Commercial Finance Committee of the American Bar Association published an annotated model form of intercreditor agreement that addresses a number of the issues that are frequently negotiated in the intercreditor agreement. The form is available on the ABA website at http://apps.americanbar.org/dch/committee.cfm?com=CL190029. References below to the model form are from the form produced by the ABA committee. Although the model form is helpful, parties still engage in meaningful negotiations with respect to the terms of the intercreditor agreement.

c. How Is Intercreditor Agreement Enforced In Bankruptcy?

i. Subordination Provisions

The heart of the intercreditor agreement is a set of provisions that provide that senior lenders have priority over junior lenders with respect to the priority of their liens in collateral of the Borrower (in the case of lien subordination) and/or the priority of payments received from the Borrower (in the case of payment subordination). Bankruptcy Courts routinely enforce such provisions relying on 11 U.S.C. § 510(a) which provides that a subordination agreement is enforceable in bankruptcy to the same extent that it is enforceable under applicable nonbankruptcy.[8] Thus, to the extent the

[8] Section 510(a) of the Bankruptcy Code provides:

Intercreditor Agreement is considered a "subordination agreement" based upon the lenders' intention to subordinate one lender's rights against the borrower to those of another lender and the Intercreditor Agreement is otherwise enforceable under state law, the Bankruptcy Court should enforce it.

ii. Non-Subordination Provisions

When considering the enforceability of intercreditor agreement provisions that go beyond subordination, including provisions that waive bankruptcy rights by the lenders, the courts have been inconsistent. Some courts have interpreted all provisions contained within the Intercreditor Agreement as constituting a subordination agreement enforceable under section 510(a). Other courts have parsed through the Intercreditor Agreement and undertaken a separate analysis of whether provisions that go beyond providing for relative priority among lenders are enforceable. Those courts then balance on the one hand, a public policy favoring the freedom of contract between sophisticated parties, and on the other hand, a public policy in favor of fundamental bankruptcy rights. Some courts have come out in favor of freedom of contract, even where the terms of the agreement directly conflict with the Bankruptcy Code (*see Broadcast Capital, Inc. v. Davis Broad., Inc.* (*In re Davis Broad., Inc.*), 169 B.R. 229, 234 (Bankr. M.D. Ga. 1994), rev'd on other grounds, 176 B.R. 290 (M.D. Ga. 1994)) while others have refused to recognize attempts by parties to contract around the Bankruptcy Code and waive fundamental rights of a lender (*see In re Hinderliter Indus., Inc.,* 228 B.R. 848, 850 (Bankr. E.D. Tex. 1999); *Beatrice Foods Co. v. Hart Ski Mfg. Co.* (*In re Hart Ski Mfg. Co., Inc.*), 5 B.R. 734, 736 (Bankr. D. Minn. 1980)).

The Applicable Model Intercreditor Agreement provision states:

> 6.11 EFFECTIVENESS IN INSOLVENCY PROCEEDINGS
>
> The Parties acknowledge that this Agreement is a "subordination agreement" under section 510(a) of the Bankruptcy Code, which will be effective before, during, and after the commencement of an Insolvency Proceeding.

d. <u>Enforceability of Bankruptcy Waivers in Intercreditor Agreements</u>

i. Right to Challenge the Claims or Liens of Priority Lenders.

Courts have generally upheld intercreditor provisions in which junior creditors waive the right to challenge liens of senior creditors. *See In re ION Media Networks, Inc.*, 419 B.R. 585 (Upholding waiver in intercreditor agreement by second lien lenders of right to challenge liens of first lien lenders).

The applicable Model Intercreditor Agreement provisions states:

> 6.8 POST-PETITION CLAIMS
>
> (a) No Second Lien Claimholder may oppose or seek to challenge any claim by a First Lien Claimholder for allowance or payment in any Insolvency Proceeding of First Lien Obligations consisting of Post-Petition Claims.

"(a) A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a).

(b) No First Lien Claimholder may oppose or seek to challenge in an Insolvency Proceeding a claim by a Second Lien Claimholder for allowance [and any payment permitted under section 6.4, "Adequate Protection,"] of Second Lien Obligations consisting of Post-Petition Claims.

Many intercreditor agreements go further and also bar challenges to claims as well as attempts to disallow, recharacterize or subordinate claims of senior lenders.

ii. Right to Object to DIP Financing or Use of Cash Collateral.

First lien lenders often negotiate for waivers pursuant to which the subordinate lender agrees not to object to efforts by the first lien lender to provide Debtor in Possession financing to or permit the use of cash collateral by the borrower. The second lien lender usually requires some restrictions on the amount and terms of the DIP financing or use of cash collateral. Common restrictions include (1) retention of liens by subordinate lenders, (2) cap on amount of financing, (3) priority of liens granted to secure DIP Financing, (4) absence of provisions dictating terms of plan and/or sale, (5) reasonableness of commercial terms of financing proposal, (6) ability to "roll up" prepetition debt and (7) limitations on carve-outs for professional fees and other case expenses. Subordinate creditors often negotiate for an exception from the waiver that permits them to raise any objection that could be raised by an unsecured (as opposed to secured) creditor. (See Section 11 below.)

Courts have enforced waivers of the right to object to DIP financing and use of cash collateral where the waivers are clear and unambiguous. *See Aurelius Capital Master, Ltd. v. Tousa Inc.*, No. 08-61317-CIV, 2009 WL 6453077 (S.D. Fla. Feb. 6, 2009)(bankruptcy court approved the cash collateral order over the second-lien lenders' objection, concluding that the second-lien lenders lacked standing to object as they had clearly "bargained away [their] right to object by entering into the Intercreditor Agreement" waiving such right).

The applicable Model Intercreditor Agreement states that:

6.1 (a) Until the Discharge of First Lien Obligations up to the First Lien Cap with respect to the Capped Obligations and in their entirety with respect to First Lien Obligations that are not Capped Obligations, if an Insolvency Proceeding has commenced, Second Lien Agent, as holder of a Lien on the Collateral, will not contest, protest, or object to, and each Second Lien Claimholder will be deemed to have consented to,

(1) any use, sale, or lease of "cash collateral" (as defined in section 363(a) of the Bankruptcy Code), and

(2) Borrower or any other Grantor obtaining DIP Financing if First Lien Agent consents in writing to such use, sale, or lease, or DIP Financing, provided that

(A) Second Lien Agent otherwise retains its Lien on the Collateral, [and]

(B) any Second Lien Claimholder may seek adequate protection as permitted by section 6.4, "Adequate Protection," and,

if such adequate protection is not granted, Second Lien Agent may object under this section 6.1 solely on such basis[.][,]

[(C) after taking into account the use of cash collateral and the principal amount of any DIP Financing (after giving effect to any Refinancing of First Lien Obligations) on any date, the sum of the then outstanding principal amount of any First Lien Obligations and any DIP Financing does not exceed the First Lien Cap on such date,

(D) such DIP Financing and the Liens securing such DIP Financing are pari passu with or superior in priority to the then outstanding First Lien Obligations and the Liens securing such First Lien Obligations, and

(E) the interest rate, fees, advance rates, lending limits, and sublimits are commercially reasonable under the circumstances.] [Upon written request from First Lien Agent, Second Lien Agent, as holder of a Lien on the Collateral, will join any objection by First Lien Agent to the use, sale, or lease of cash collateral for any purpose other than adequate protection payments to Second Lien Claimholders.]

[(b) Any customary "carve-out" or other similar administrative priority expense or claim consented to in writing by First Lien Agent to be paid prior to the Discharge of First Lien Obligations up to the First Lien Cap with respect to the Capped Obligations and in their entirety with respect to First Lien Obligations that are not Capped Obligations will be deemed for purposes of section 6.1(a)

(3) to be a use of cash collateral, and

(4) [not to be] a principal amount of DIP Financing at the time of such consent.]

[(c) nothing in this section 6.1 limits or impairs the right of Second Lien Agent to object to any motion regarding DIP Financing (including a DIP Financing proposed by one or more First Lien Claimholders) or cash collateral to the extent that

(5) the objection could be asserted in an Insolvency Proceeding by unsecured creditors generally[, is consistent with the other terms of this section 6.1, and is not based on the status of any Second Lien Claimholder as holder of a Lien], or

(6) the DIP Financing does not meet the requirements of section 6.1(a).]

iii. Right to Propose DIP Financing.

Another way for a subordinate creditor to "object" to DIP Financing is to offer a competing alternative DIP proposal. As a result, first lien lenders commonly negotiate for restrictions on a subordinate lender providing DIP Financing. The waiver may be an absolute bar or it may be conditioned on any circumstance in which the first lien lender

has made or even is supportive of DIP proposal. The waiver may preclude a priming DIP by the junior creditor in any event.

The applicable Model Intercreditor Agreement provision provides:

> 6.1 [No Second Lien Claimholder may provide DIP Financing to a Borrower or other Grantor secured by Liens equal or senior in priority to the Liens securing any First Lien Obligations[, provided that if no First Lien Claimholder offers to provide DIP Financing to the extent permitted under section 6.1(a) on or before the date of the hearing to approve DIP Financing, then a Second Lien Claimholder may seek to provide such DIP Financing secured by Liens equal or senior in priority to the Liens securing any First Lien Obligations, and First Lien Claimholders may object thereto].]

iv. Right to Seek Relief from the Automatic Stay.

Every creditor has the right to seek relief from the automatic stay if its interest in its collateral is not or cannot be adequately protected against decreases in value while the debtor is in bankruptcy. 11 U.S.C. § 362(d). Because its interest in the collateral is primary, first lien lenders negotiate for junior lenders to waive their right to seek stay relief and not agree not to oppose any stay relief sought by the first lien lender. At least one court has refused to enforce such a provision. *See In re Hart Ski Manufacturing Co., Inc.*, 5 B.R. 734 (Bankr. D. Minn. 1980)(holding that "the Bankruptcy Code guarantees each secured creditor certain rights, regardless of subordination… [including] the right to have a stay lifted under proper circumstances" and that these rights "cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case").

Notwithstanding, such case law, waivers of the right to seek relief from the automatic stay are common in intercreditor agreements.

The applicable Model Intercreditor Agreement provision states:

> 6.3 RELIEF FROM THE AUTOMATIC STAY
>
> Until the Discharge of First Lien Obligations up to the First Lien Cap with respect to the Capped Obligations and in their entirety with respect to First Lien Obligations that are not Capped Obligations, no Second Lien Claimholder may[, during any Standstill Period,] seek relief from the automatic stay or any other stay in an Insolvency Proceeding in respect of the Collateral without First Lien Agent's prior written consent [or oppose any request by First Lien Agent for relief from such stay] [, except to the extent that [a First Lien Claimholder (in such capacity)] [First Lien Agent] seeks or obtains relief from or modification of such stay[, or a motion for adequate protection permitted under section 6.4, "Adequate Protection," is denied by the Bankruptcy Court]].

v. Right to Seek Adequate Protection.

The Bankruptcy Code gives all secured lenders the right to adequate protection against decreases in the value of their collateral while the Debtor is in bankruptcy. The inability to provide adequate protection is grounds for stay relief. First lien lenders negotiate for junior lenders to waive their right to adequate protection so that they are unimpeded in their efforts to make sure that they receive adequate protection. Junior

lenders commonly agree to such provisions on the basis that the first lien lender must be paid in full before they can recover in any event. Most intercreditor agreements provide that junior lenders can receive additional or replacement liens on all collateral securing the first lien obligations. The rights of junior lenders to other forms of adequate protection vary.

The applicable Model Intercreditor Agreement provision states:

6.4 ADEQUATE PROTECTION

(a) No Second Lien Claimholder will contest, protest, or object to

(1) a request by a First Lien Claimholder for "adequate protection" under any Bankruptcy Law, or

(2) an objection by a First Lien Claimholder to a motion, relief, action, or proceeding based on a First Lien Claimholder claiming a lack of adequate protection.

(b) Notwithstanding the preceding section 6.4(a), in an Insolvency Proceeding:

(1) Except as permitted in this section 6.4, no Second Lien Claimholders may seek or request adequate protection or relief from the automatic stay imposed by section 362 of the Bankruptcy Code [or other relief].

(2) [If a First Lien Claimholder is granted adequate protection in the form of additional or replacement Collateral in connection with a motion described in section 6.1, "Use of Cash Collateral and DIP Financing," then] Second Lien Agent may seek or request adequate protection in the form of a Lien on [such] additional or replacement Collateral, which Lien will be subordinated to the Liens securing the First Lien Obligations and any DIP Financing (and all related Obligations) on the same basis as the other Liens securing the Second Lien Obligations are subordinated to the Liens securing First Lien Obligations under this Agreement.

(3) Any claim by a Second Lien Claimholder under section 507(b) of the Bankruptcy Code will be subordinate in right of payment to any claim of First Lien Claimholders under section 507(b) of the Bankruptcy Code and any payment thereof will be deemed to be Proceeds of Collateral[, provided that, subject to section 6.7, "Reorganization Securities," Second Lien Claimholders will be deemed to have agreed pursuant to section 1 129(a)(9) of the Bankruptcy Code that such section 507(b) claims may be paid under a plan of reorganization in any form having a value on the effective date of such plan equal to the allowed amount of such claims].

[(4) So long as First Lien Agent is receiving payment in cash of [all] Post-Petition Claims [consisting of all interest at the applicable rate under the First Lien Loan Documents], Second Lien Agent may seek and, subject to the terms hereof, retain payments of Post-Petition Claims [consisting of interest at the [non-default] [applicable] rate] under the

Second Lien Loan Documents (Second Lien Adequate Protection Payments). If a Second Lien Claimholder receives Second Lien Adequate Protection Payments before the Discharge of First Lien Obligations up to the First Lien Cap with respect to the Capped Obligations and in their entirety with respect to First Lien Obligations that are not Capped Obligations, then upon the effective date of any plan or the conclusion or dismissal of any Insolvency Proceeding, the Second Lien Claimholder will pay over to First Lien Agent pursuant to section 4.1, "Application of Proceeds," an amount equal to the lesser of (i) the Second Lien Adequate Protection Payments received by the Second Lien Claimholder and (ii) the amount necessary to Discharge the First Lien Obligations. [Notwithstanding anything herein to the contrary, First Lien Claimholders will [not] be deemed to have consented to, and expressly [waive] [retain] their rights to object to, the payment of Second Lien Adequate Protection Payments.]]

vi. Right to Post-Petition Interests/Fees.

The Bankruptcy Code provides for payment of post-petition interest and attorney's fees only on the secured portion of a lenders' claim. 11 U.S.C. § 502(b)(2). Sometimes, the intercreditor agreement will include a provision that grants the first lien lender the right to receive payment of post-petition interest and fees on its obligations (both secured and unsecured) before the junior lender can be paid. This results in the payments being made from funds that would otherwise go to the junior lender. Courts generally uphold such provisions if they are explicit.

The applicable Model Intercreditor Agreement provision states:

DEFINITIONS. Obligations means all obligations of every nature of a Person owed to any obligee under an agreement, whether for principal, interest, or payments for early termination, fees, expenses, indemnification, or otherwise, and all guaranties of any of the foregoing, whether absolute or contingent, due or to become due, now existing or hereafter arising, and including interest and fees that accrue after the commencement by or against any Person of any proceeding under any Bankruptcy Law naming such Person as the debtor in such proceeding, ***regardless of whether such interest and fees are allowed claims in such proceeding***.

* * *

6.8 POST-PETITION CLAIMS

(a) No Second Lien Claimholder may oppose or seek to challenge any claim by a First Lien Claimholder for allowance or payment in any Insolvency Proceeding of First Lien Obligations consisting of Post-Petition Claims.

(b) No First Lien Claimholder may oppose or seek to challenge in an Insolvency Proceeding a claim by a Second Lien Claimholder for allowance [and any payment permitted under section 6.4, "Adequate

Protection,"] of Second Lien Obligations consisting of Post-Petition Claims.

vii. Right to Object to Sale of Collateral under Section 363.

Secured lenders have the right to object to a sale of their collateral free and clear of their liens unless the conditions set forth in 11 U.S.C. § 363(f) are satisfied.[9] As a result, a nonconsenting junior lender may conceivably block a sale that is supported by the senior lender. Junior lenders generally agree to waive their right to object to the sale of their collateral provided that (1) their liens attach to the proceeds of sale or (2) the proceeds are used to repay the obligations owed to the senior lender. Some junior lenders negotiate for the right to credit bid as consideration for waiving their sale objection rights. Credit bid rights granted to junior lenders are generally conditioned on the senior lender being paid in full in cash at the closing of the sale. Waiver of credit bid rights are rare.

The applicable Model Intercreditor Agreement provision provides:

6.2 SALE OF COLLATERAL

Second Lien Agent, as holder of a Lien on the Collateral and on behalf of the Second Lien Claimholders, will not contest, protest, or object, and will be deemed to have consented pursuant to section 363(f) of the Bankruptcy Code, to a Disposition of Collateral free and clear of its Liens or other interests under section 363 of the Bankruptcy Code if First Lien Agent consents in writing to the Disposition, provided that

(a) either (i) pursuant to court order, the Liens of Second Lien Claimholders attach to the net Proceeds of the Disposition with the same priority and validity as the Liens held by Second Lien Claimholders on such Collateral, and the Liens remain subject to the terms of this Agreement, or (ii) the Proceeds of a Disposition of Collateral received by First Lien Agent in excess of those necessary to achieve the Discharge of First Lien Obligations, up to the First Lien Cap with respect to the Capped Obligations and in their entirety with respect to First Lien Obligations that are not

[9] 11 U.S.C. § 363(f) provides as follows:

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

> Capped Obligations, are distributed in accordance with the U.C.C. and applicable law[,] [.]
>
> [(b) the net cash Proceeds of the Disposition that are applied to First Lien Obligations permanently reduce the First Lien Obligations pursuant to section 4.1, "Application of Proceeds," or if not so applied, are subject to the rights of Second Lien Agent to object to any further use notwithstanding section 6.1(a), and
>
> (c) Second Lien Claimholders [may] [are not deemed to have waived any rights to] credit bid on the Collateral in any such Disposition in accordance with section 363(k) of the Bankruptcy Code.]
>
> Notwithstanding the preceding sentence, Second Lien Claimholders may object to any Disposition of Collateral that could be raised in an Insolvency Proceeding by unsecured creditors generally [so long as not otherwise inconsistent with the terms of this Agreement].

viii. Right to Vote on Bankruptcy Plan – Plan Classification.

In a 1st lien/2nd lien structure, the claims of 1st lien lenders and the claims of 2nd lien lenders are separately classified under a plan of reorganization. As such, the 1st lien lenders control the vote of the claims of 1st lien lenders and the 2nd lien lenders control the vote of the claims of 2nd lien lenders. Under Section 1126(c) of the Bankruptcy Code,

> "(c) A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan." 11 U.S.C. § 1126(c).

Section 1122(a) of the Bankruptcy Code provides that

> "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." 11 U.S.C. § 1122(a).

If the senior lenders and the junior lenders are not separately classified there is a risk that one tranche of lenders may hold a blocking position or a control position with respect to voting on a proposed plan. Where one tranche of lenders has a control position (more than 1/2 in number and at least 2/3 in amount of claims) and votes in favor of a plan, this would result in the plan proponent being relieved of its obligation (1) to demonstrate that the plan is in the best interest of creditors under 11 U.S.C. § 1129(a)(7), and (2) that the plan is fair and equitable under 11 U.S.C. § 1129(b).

> Section 1129(a)(7) requires as a condition of confirmation of a plan that each class of claims or interests – (i) has accepted the plan; or (ii) will receive or retain under the plan on account of such claim or interest property of a value, on the effective date of the plan, that is not

> less than the amount that such holder would receive or retain if the debtor were liquidated under Chapter 7 of this title on such date"
>
> Section 1129(b)(1) provides that the Court "shall confirm the plan [even if all classes have not accepted the plan] if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted the plan.

For the plan to be fair and equitable, the lender class would need to retain its liens on the debtor's assets, and the plan must provide for a stream of payments to the lenders over a reasonable period of time and accruing at an interest rate that reflects the "present value" of the lenders' claims as of the effective date of the plan. Presumably, if one tranche lenders controlled the vote of the class of all lenders under the plan, they could cause the class to accept a plan that fundamentally altered the rights of the lenders agreed to in the Intercreditor Agreement over the objection and without the consent of the other tranche of lenders. As a result, the Intercreditor Agreement generally provides for separate classification of the senior and junior lender claims.

The applicable Model Intercreditor Agreement provision states:

> 6.10 SEPARATE GRANTS OF SECURITY AND SEPARATE CLASSIFICATION
>
> The grants of Liens pursuant to the First Lien Collateral Documents and the Second Lien Collateral Documents constitute two separate and distinct grants. Because of, among other things, their differing rights in the Collateral, the Second Lien Obligations, to the extent deemed to be "secured claims" within the meaning of section 506(b) of the Bankruptcy Code, are fundamentally different from the First Lien Obligations and must be separately classified in any plan of reorganization in an Insolvency Proceeding. Second Lien Claimholders will not seek in an Insolvency Proceeding to be treated as part of the same class of creditors as First Lien Claimholders and will not oppose or contest any pleading by First Lien Claimholders seeking separate classification of their respective secured claims.

ix. Right to Support/Object to Bankruptcy Plan.

To maximize its ability to exit the bankruptcy process and avoid undesirable treatment under a plan, the first lien lender may seek to limit the subordinate lenders' rights with respect to plan voting. Such provisions are usually resisted by subordinate lenders and the Courts have been inconsistent in enforcing such waivers. The form of such restriction may vary but generally take one of the following forms:

(1) Junior lender assigns all voting rights to senior lender and takes its direction on how to vote; *see In re Coastal Broad. Systems, Inc.*, No. 11-10596, 2012 WL 2803745 (Bankr. D. N.J. July 6, 2012), *aff'd by Rosenfeld v. Coastal Broad Systems, Inc.*, No. 12-5682, 2013 WL 3285936 (D.N.J. June 28, 2013)(enforcing assignment of voting rights); *Blue Ridge Investors, II, LP v. Wachovia Bank N.A. & Aerosol Packaging, LLC* (*In re Aerosol Packaging, LLC*), 362 B.R. 43 (Bankr. N.D. Ga. 2006)(same); *But See*, *Bank of America*, *National Association v. North*

LaSale St. Ltd. P'ship (*In re 203 N. LaSalle St. P'ship),* 246 B.R. 325 (Bankr. N.D. Ill. 2000)(refusing to enforce assignment of voting right holding that the "voting rights" provision of the subordination agreement, which was unrelated to the distribution and priority of payments, could not override the subordinated lender's right to vote its claim pursuant to Section 1126(a) of the Bankruptcy Code);

(2) Junior lender agrees not to vote in favor of a plan unless senior lender supports the plan;

(3) Junior lender agrees not to support a plan unless it pays senior lender in full in cash on the effective date; and

(4) Junior lender agrees not to support any plan that is inconsistent with the intercreditor agreement.

x. Right to Keep Reorganization Securities.

The plan of reorganization may provide for the distribution of debt or equity securities to the subordinate lender on account of their claims. The Intercreditor Agreement may address whether these securities (referred to reorganization securities) may be retained by the subordinate lender or must be turned over to the senior lender. This clause in the intercreditor agreement is known as the "X Clause".

The applicable Model Intercreditor Agreement provision provides:

6.7 REORGANIZATION SECURITIES

Nothing in this Agreement prohibits or limits the right of a Second Lien Claimholder to receive and retain any debt or equity securities that are issued by a reorganized debtor pursuant to a plan of reorganization or similar dispositive restructuring plan in connection with an Insolvency Proceeding[, provided that any debt securities received by a Second Lien Claimholder on account of a Second Lien Obligation that constitutes a "secured claim" within the meaning of section 506(b) of the Bankruptcy Code will be paid over or otherwise transferred to First Lien Agent for application in accordance with section 4.1, "Application of Proceeds," unless such distribution is made under a plan that is consented to by the affirmative vote of all classes composed of the secured claims of First Lien Claimholders].

If, in an Insolvency Proceeding, debt Obligations of the reorganized debtor secured by Liens upon any property of the reorganized debtor are distributed pursuant to a plan of reorganization or similar dispositive restructuring plan, both on account of First Lien Obligations and on account of Second Lien Obligations, then, to the extent the debt Obligations distributed on account of the First Lien Obligations and on account of the Second Lien Obligations are secured by Liens upon the same property, the provisions of this Agreement will survive the distribution of such debt Obligations pursuant to such plan and will apply with like effect to the Liens securing such debt Obligations.

xi. Rights of Unsecured Creditor.

Some Intercreditor Agreements will contain an override provision, preserving for the junior lender all rights of an unsecured creditor in a bankruptcy case. Unsecured creditor rights can provide significant leverage in a bankruptcy case and include: (1) the right to accelerate the obligations owed by the borrower and sue for collection, (2) the right to file an involuntary bankruptcy case[10], and (3) the right to object to DIP Financing or assets sale on grounds of best interest of estate, reasonableness of terms or process for procuring transaction.

Often provisions preserving rights of an unsecured creditor are overly broad and inconsistent with specific bankruptcy waivers. Care should be taken in drafting (1) to avoid ambiguity, (2) to narrowly tailor any preservation of rights of an unsecured creditor, and (3) to make clear that where the subordinated creditor has waived its rights (for example, with respect to DIP Financing or sale of assets) that there are not exceptions to the restrictions. It is a good idea to include language that prohibits any action even as unsecured creditors, to the extent such actions would contravene the intended purpose of the applicable intercreditor agreement. *See In re MPM Silicones, LLC*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014)(Court held that actions taken by second lien lenders in violation of intercreditor agreement had been taken by second lien lenders in their role as unsecured creditors and were permitted by general exception for such in the intercreditor agreement).

The applicable provision of the Model Intercreditor Agreement states:

> 3.1(d) [Notwithstanding any provision of this Agreement] [Except as otherwise expressly set forth in this section 3.1 [and _____]], Second Lien Claimholders may exercise any rights and remedies that could be exercised by an unsecured creditor [other than initiating or joining in an involuntary case or proceeding under the Bankruptcy Code with respect to a Grantor] [prior to the end of the Standstill Period] against a Grantor that has guaranteed or granted Liens to secure the Second Lien Obligations in accordance with the terms of the Second Lien Loan Documents and applicable law, *provided* that any judgment Lien obtained by a Second Lien Claimholder as a result of such exercise of rights will be included in the Second Lien Collateral and be subject to this Agreement for all purposes (including in relation to the First Lien Obligations).

[10] 11 U.S.C. § 303(b).