

ALERTS

Fifth Circuit Affirms Bankruptcy Court's Reasonableness Review of Oversecured Lender's Legal Fees in Non-Judicial Foreclosure Sale

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The U.S. Court of Appeals for the Fifth Circuit held on June 23, 2014 that an oversecured lender's legal fees were subject to the bankruptcy court's review for reasonableness despite a court-ordered non-judicial foreclosure sale of the lender's collateral. *In re 804 Congress, LLC*, __ F.3d __, 2014 WL 2816521 (5th Cir. June 23, 2014). Affirming the bankruptcy court's power and reversing the district court, the Fifth Circuit found the lender's utter failure to detail its legal fees with any documentary support to be fatal.

Facts

The debtor had financed the purchase of a Texas office building with a note ("Note") and a Deed of Trust Security Agreement/Financing Statement ("Deed of Trust"), giving its lender ("Bank") a first lien on the building. The Note entitled the Bank to be paid its reasonable attorneys' fees following a default.

The debtor filed a Chapter 11 petition to avoid the Bank's scheduled foreclosure sale. The Bank promptly moved in the bankruptcy court to lift the automatic stay for "a non-judicial foreclosure sale of the property." The bankruptcy court granted the motion, permitting the Bank "to conduct a foreclosure sale of the Property . . . in accordance with applicable state laws." *Id.* at *1.

The non-judicial foreclosure sale yielded proceeds of approximately \$4.355 million. Under the Deed of Trust, the Bank was entitled to be paid the “full amount of principal, interest, attorney’s fees, and other charges”: \$3.3 million, including pre-petition and post-petition legal fees of more than \$87,000. *Id.* at *1.

The bankruptcy court took jurisdiction over distributing the sale proceeds after the U.S. Trustee objected to the Deed of Trust trustee’s (“Deed Trustee”) motion to distribute proceeds. The Bank and the Deed Trustee each filed claims for what they were owed under the Deed of Trust. In response, the bankruptcy court directed the Deed Trustee to pay the Bank its entire claim except for the legal fees it sought, reasoning that the Bank “had not filed a proper application for fees” nor provided “supporting documentation or testimony that the fees were reasonable.” *Id.* at *2. Section 506(b) of the Bankruptcy Code (“Code”) provides that when a creditor’s claim is oversecured (i.e., the collateral is worth more than the amount of the creditor’s underlying claim), the creditor is entitled to post-petition interest plus “any *reasonable* fees, costs, or charges provided for under the agreement.” *Id.* at *2 (emphasis added).

The Bank appealed to the district court, which held that “when the bankruptcy court lifted the stay and the foreclosure sale occurred, the bankruptcy court ceased to have jurisdiction over the property and sale proceeds.” *Id.* at *2. The distribution of the sale proceeds, in its view, was governed by Texas law rather than federal bankruptcy law. The debtor appealed to the Fifth Circuit.

The Fifth Circuit’s Review

The Fifth Circuit held that “federal law [i.e., Code § 506(b)] governs what is to be distributed to . . . [an] oversecured” lender, “regardless of state law.” 2014 WL 2816521 at *3, 4. Moreover, the bankruptcy court’s lifting of the automatic stay for a non-judicial foreclosure under state law “did not give the [Deed Trustee] any further authority and did not have the effect of insulating the debtor or any of the creditors from the reach of § 506(b).” Additionally, said the court, “Lifting the automatic stay to allow [the Bank] to foreclose was not tantamount to an abandonment of property.” *Id.* at *5.

The court then reviewed the bankruptcy court’s determination of the reasonableness of the Bank’s legal fees under an abuse of discretion

standard. According to the Fifth Circuit, the bankruptcy court had not erred in finding the Bank's legal fees were unsubstantiated and thus unreasonable: "[T]here was no documentation of the time that was spent and no testimony as to what was a reasonable fee." *Id.* at *6.

Other circuits, the court noted, have found that unreasonable fees were still allowable as unsecured claims instead of being disallowed. *Id.* at *6-7. *See, e.g., In re Welzel*, 275 F.3d 1308, 1318 (11th Cir. 2001) (en banc) ("If a portion of the [legal] fees are deemed unreasonable . . . [then] the fees should be bifurcated between the reasonable portion, treated as a secured claim, and the unreasonable portion, treated as an unsecured claim."). Because it was unclear whether this issue had been raised in the lower courts and because the parties had barely briefed the issue, the Fifth Circuit left it to the bankruptcy court to determine whether the Bank could file an unsecured claim for reimbursement under Code Section 502. *Id.* at *8.

Comments

To ensure recovery of contractually negotiated-for attorneys' fees, an oversecured lender should detail all legal fees, costs and expenses with supporting documentation. Bills for services supported by time records often suffice, but note that the Eleventh Circuit in *Welzel* found a \$147,000 bill, based on a "contractually set" 15 percent fee, to be unreasonable in view of \$40,000 in actual time charges. 275 F.3d at 1311.

Alternatively, the lender might add a provision regarding distribution in the order modifying the stay to permit foreclosure, such as the following: The foreclosure and distribution will be made exclusively under applicable state law, with any dispute regarding the procedure or distribution to be decided by any state court with competent jurisdiction. In *804 Congress*, however, the court noted a reasonableness requirement under Texas law. 2014 WL 2816521 at *6.

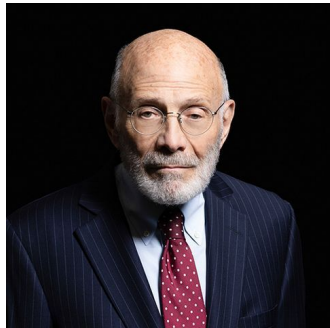
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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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