Critical Issues Involving Claims for Post-Petition Interest and Attorney’s Fees Under Section 502(b)(2) and 506(b) of the Bankruptcy Code

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Parties who loan money or extend credit to a business debtor often require a promissory note or other agreement that provides for repayment of the principal amount due, plus interest. Astute lenders also provide for a default rate of interest, late fees, and attorneys’ fees that are triggered upon the occurrence of certain defined defaults. Most states have laws that pertain to collection of attorneys’ fees in the event of default.

The Bankruptcy Code has specific sections that address the right to inter-

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CRITICAL ISSUES INVOLVING CLAIMS FOR POST-PETITION INTEREST AND ATTORNEY’S FEES UNDER SECTION 502(b)(2) AND 506(b) OF THE BANKRUPTCY CODE

Interest, late fees and attorneys’ fees. Bankruptcy Courts have inconsistently interpreted the Code sections in ways that impact fully secured, under-secured, and unsecured creditors. Some of the rulings are very interesting, surprising and contrary to what even experienced bankruptcy practitioners expect. This article will examine many of the issues which arise and key decisions that address them.

A. Interplay of Sections 502(b)(2) and 506

Under section 502 of the Bankruptcy Code, “[a] claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . objects.” Section 502 further provides that 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 section 502(b) applies to the claim. Pursuant to section 502(b), the court shall allow the claim unless,

1. such claim is unenforceable against the debtor and property of 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; . . .

If an objection to a claim is made, the bankruptcy court will determine the allowed amount of the claim as of the petition date, and will disallow the claim to the extent that one of the exceptions enumerated in section 502(b) applies.

The decision of the Supreme Court in Vanston Bondholders Protective Committee v. Green provides guidance on the reason for disallowance of post-petition interest on unsecured claims: “(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 recomputing 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.”

Of course, if the debtor is solvent, payments to unsecured creditors can include post-petition interest, and possibly other charges, depending on the facts of the case.

The general rule embodied in section 502(b)(2) does not preclude the recovery of post-petition interest by an over-secured creditor to the extent of the value of its collateral. This exception to the general rule is now contained in section 506(b) which provides that:

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 State statute under which such claim arose.

Although section 506(b) of the Bankruptcy Code allows over-secured creditors to potentially recover post-petition interest and any reasonable fees, costs, or charges, the Bankruptcy Code does not include a similar code section clearly providing for the recovery by unsecured or under-secured creditors.
creditors of fees, costs, and charges. Nevertheless, some courts are allowing post-petition attorneys’ fees to undersecured and unsecured creditors. This article will first consider allowance of interest and then discuss allowance of attorneys’ fees.

B. Recent Developments on Allowance of Interest

1. Awards of Prepetition Interest

As a general rule, prepetition interest is available to secured and unsecured creditors as long as the claim for interest is not unenforceable against the debtor under any agreement or applicable law. Bankruptcy courts will typically award interest at the contract rate, unless the contractual provision is unenforceable under applicable law. Thus, courts have awarded a default rate of interest on prepetition claims where no usury or other state laws are violated.

In In re 785 Partners LLC, the bankruptcy court for the Southern District of New York was called upon to determine, among other things, whether to allow prepetition interest at the contractual default rate to an undersecured creditor that had acquired the loan from prior lenders. The court decided to award prepetition default interest and declined to abate the rate, stating that a judge cannot adjust a prepetition claim and rewrite the parties bargained for contract based on its own notions of fairness and equity. The court also pointed out that the contractual default interest rate “reflects the allocation of risk as part of the bargain struck between the parties” and is not a penalty. The court rejected the debtor’s argument that because the claimant was an assignee that had purchased the loan while the debtor was in default and presumably at a discount, imposition of the default rate inequitably provided a windfall to the claimant. Rather, the court concluded that an assignee stands in the shoes of the original lender and can assert the same rights as would have been available to the original lenders.

2. Awards of Post-Petition Interest

As a general proposition, post-petition interest is not permitted under the Bankruptcy Code because the filing of the petition stops the accrual of interest. However, the Bankruptcy Code provides limited exceptions to this rule for both unsecured and oversecured creditors.

a. Unsecured Creditors

In distributing assets of the estate, the payment of post-petition interest at the legal rate to holders of allowed non-priority unsecured claims is required in a case where the estate is solvent before there can be a distribution to the last holder in priority, the debtor. Specifically, Bankruptcy Code § 726(a) provides in relevant part:

Except as provided in section 510 of this title, property of the estate shall be distributed

. . . (5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3) or (4) of this subsection; . . .
Thus, in the case of a solvent chapter 7 estate, a holder of an allowed general unsecured claim is also entitled to receive interest on such claim at the legal rate before a distribution can be made to the debtor.\textsuperscript{14}

In a chapter 11 case, section 1129(a)(7) requires the payment of post-petition interest at the legal rate if the claimant holds an impaired claim, voted to reject the plan and would receive payment under the 5\textsuperscript{th} priority distribution under § 726(a) in a hypothetical chapter 7 liquidation.\textsuperscript{15} Courts have determined that the legal rate of interest under § 726(a)(5) is the federal judgment rate.\textsuperscript{16}

In \textit{In re Energy Future Holdings Corp.},\textsuperscript{17} the bankruptcy court for the District of Delaware considered how plan confirmation issues determine whether post-petition interest must or should be paid with respect to allowed unsecured claims in a solvent debtor case. The court first determined that the plain language of section 1129(b)(2) does not require payment to unsecured creditors of post-petition interest even where junior classes will receive a distribution. Pursuant to section 502(b)(2), the allowed amount of an unsecured claim does not include post-petition interest. The right to receive legal rate interest under section 726(a) is separate from the allowed claim itself, and section 1129(b)(2)(B)(i) only requires payment in full of the allowed claim amount, not any other right to post-petition interest.\textsuperscript{18}

The court next examined whether the plan’s proposed treatment to pay the unsecured creditors in full with interest at the federal judgment rate left them impaired. The court first noted that under section 1129(a)(7), unsecured creditors in a solvent debtor case are entitled, at the very least, to the payment of post-petition interest at the federal judgment rate, which the court could adjust for equitable reasons. The court did not find a contractual or legal right to receive the contract rate, but did state there may be an equitable right to receive the contract rate. With regard to a contractual right, the court held that section 502(b) is a law that changes the contractual rights to which the claim entitles the holder (by disallowing unmatured post-petition interest altogether), and therefore the exclusion of post-petition interest at the contract rate on the unsecured claims did not impair their claims. Ultimately the court concluded that in a solvent debtor case, the fair and equitable test under section 1129(b)(2) required for plan confirmation must also be met to deem a creditor unimpaired, and that this test requires the debtor to either provide in the plan for the payment of post-petition interest or provide that the court may award such interest in its discretion. In either case, the rate would be the contract rate or such other rate the court deemed appropriate.\textsuperscript{19}

\textbf{b. Oversecured Creditors}

Under section 506(b) an oversecured creditor is entitled to post-petition interest on its secured claim up to the value of the collateral securing its claim.\textsuperscript{20} To the extent that the value of the creditor’s collateral exceeds the claim amount and post-petition interest has accrued and is unpaid as of the effective date of a plan, it is added to the secured claim and paid pursuant to the terms of the plan with plan interest as determined by section 1129.\textsuperscript{21} The
determination of oversecured status is often a complex issue requiring the valuation of collateral at a given point in time. This article does not address valuation issues, but focuses on the appropriate rate of interest to be paid and in particular, the circumstances under which the courts will award post-petition interest at the contractual default rate.

(1) Contract Rate Interest vs. Equitable Considerations

In *U.S. v. Ron Pair*, the Supreme Court analyzed section 506(b) and held that, unlike a claim for attorneys’ fees, costs and other charges, an oversecured creditor’s entitlement to interest is “unqualified” and does not depend upon the existence of an agreement between the parties. As the case involved an oversecured tax claim as opposed to a contractual claim, the Court was not required to, and did not, decide the appropriate rate of interest to award when such a contract does exist.

After *Ron Pair*, courts were called upon to determine whether and to what extent the bankruptcy courts retained equitable discretion to award post-petition interest at a rate different from that specified in the parties’ contract. As the case law evolved, a clear majority view developed establishing a rebuttable presumption that an oversecured creditor is entitled to post-petition interest at the contractual default rate, subject to the allowability of the rate under applicable law and to adjustment of the rate on the basis of equitable considerations.

Not unexpectedly, the equitable factors courts consider in determining whether to deviate from a contractual or statutory rate, and how the courts apply them, vary among jurisdictions. While this area of law is still evolving, common factors the courts consider include (1) the existence of creditor misconduct, (2) harm to unsecured creditors resulting from application of the default rate, (3) impairment of the debtor’s fresh start, and (4) whether the rate is a penalty. Other courts have considered additional factors, such as the size and nature of the loan, the proportion of the default rate to the nondefault rate and the parties’ course of dealing.

For example, in *In re Manuel Mediavilla, Inc.*, a chapter 11 debtor submitted a plan to pay an oversecured creditor at the nondefault contract rate of interest. The oversecured creditor had acquired the loan from a prior lender, after it had been in default and through several forbearance agreements over a number of years. After noting that “the default rate of post-petition interest is presumed valid until the equities weigh against its application” the court disallowed default rate interest based on the equities, and in particular, the parties’ prebankruptcy relationship and course of dealing. The court emphasized the fact that the creditor was well aware of the debtor’s prior defaults and forbearance agreements when it acquired the loan, and, notwithstanding such defaults, both the creditor and its predecessor had not (at least for most of its relationship) sought to impose the default interest rate. The court also relied on the potential impairment of junior creditors’ claims, noting (without quantifying the impairment) that payment of the default rate would add $290,000 to the secured creditor’s claim ahead of the junior creditors.
Similarly, in *In re Perkins*, an oversecured lender petitioned the bankruptcy court for an award of post-petition interest and fees where the promissory notes at issue provided for a default rate 5% higher than the non-default rate. In ruling that the debtor had successfully rebutted the presumption in favor of awarding the contract rate, the court was persuaded by the following facts: (i) application of the default rate provided a windfall to the creditor by doubling the interest rate despite minimal risk of nonpayment given the creditor’s substantial equity cushion; and (ii) application of the default rate would “materially decrease payment, if not completely eviscerate payments to the unsecured creditors.”

While courts have been more receptive to adjusting the contractual or statutory rate paid to oversecured creditors in cases where the estate is insolvent, they have shown significantly less enthusiasm for altering the parties’ bargained for rights in solvent debtor cases.

(2) Impact of Cure of Default in Reorganization

A number of cases have addressed the appropriate rate of post-petition interest on an oversecured claim that is cured through a reorganization plan.

One line of cases, rendered predominantly by the Court of Appeals for the Ninth Circuit, has held that an oversecured creditor is not entitled to default interest when a plan proposes to fully cure the default. In *In re Entz-White*, a debtor paid an oversecured creditor the principal balance due on its matured note plus accrued interest at the nondefault contract rate on the effective date of a confirmed chapter 11 plan. On appeal of an order overruling an oversecured creditor’s plan objections, the Ninth Circuit defined the term “cure” as taking care of the event that triggered the default, thus returning the parties to pre-default conditions as if the default had never occurred. The court held that default rate interest was not appropriate when the confirmed plan provided a complete cure of the creditor’s claim, thus restoring the creditor to its pre-default status. No other circuit courts of appeal have adopted the *Entz-White* holding.

Since the *Entz-White* decision, courts in the Ninth Circuit have been reluctant to exercise discretion to abate the contractual default rate absent a complete cure of default through a chapter 11 plan. For example, in a recent Ninth Circuit BAP decision, *In re Beltway One Dev. Grp., LLC*, the court addressed the availability of default interest under a plan that proposed to extend and reamortize, rather than cure and reinstate, an oversecured creditor’s note. The bankruptcy court had apparently relied on its prior determination that the plan was fair and equitable under section 1129(b) as a basis for determining — without further analysis — that equitable considerations did not justify an award of default rate post-petition interest. The BAP ruled that the lower court improperly conflated the fair and equitable standard of section 1129(b) with the determination of post-petition default interest under section 506(b). The BAP also determined that the court’s broad equitable discretion in awarding post-petition interest was limited to very narrow circumstances where the plan nullifies all consequences of the default but some-
how fails to provide appropriate interest at the contract or legal rate as applicable. In other words, the court restricted the bankruptcy court’s discretion to deny default interest to the unlikely circumstance where a plan provides for a complete cure but does not adjust the rate down to the nondefault rate.

In 1994, Congress amended Bankruptcy Code section 1123 to add subsection (d), which provides:

> Notwithstanding subsection (a) of this section and sections 506(b), 1129(a)(7) and 1129(b) of this title, if it is proposed in a plan to cure a default the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.

Since 1994, conflicting authority has developed as to whether the reasoning of *Entz-White* and similar decisions survived the addition of subsection (d).

In particular, two courts of appeal have concluded that *Entz-White* is no longer good law. Until 2016, courts in the Ninth Circuit had not addressed the impact of this amendment on *Entz-White*.

In a 2016 decision of the Ninth Circuit Court of Appeals, *In re New Investments, Inc.*, a majority of the court determined that the *Entz-White* decision (allowing a debtor who “cures” a default through a reorganization plan to avoid all consequences of the default, including the payment of default interest) was no longer good law in light of the amendment to section 1123(d). The majority concluded that section 1123(d) requires that the court consider “how” a debtor proposes to cure a default, and in so doing, the court must now consider the underlying agreement as a whole, not just the pre-default interest provision, and applicable state law. The court stated that “consistent with section 1124(2), the debtor can return to pre-default conditions, which can include a lower, pre-default interest rate, only by fulfilling the obligations of the underlying loan agreement and applicable state law. In this case, the court was constrained to require the default rate because the promissory note provided for the higher rate upon default and state law allowed for the higher rate.

C. Recent Developments in the Allowance of Attorneys’ Fees

Sections 502 and 506 of the Bankruptcy Code are both critically important to allowance of attorneys’ fees in bankruptcy cases. Pre-petition attorneys’ fees and interest provided for under an agreement can be included in a proof of claim subject to general rules of allowability under section 502. Although section 502(b) disallows unmatured interest, it does not specifically disallow unmatured post-petition attorneys’ fees or other charges contractually agreed to by a debtor. Accordingly, the Bankruptcy Code does not, in the view of some courts, bar an unsecured claim for post-petition attorneys’ fees or other charges authorized by a pre-petition contract valid under state law.

Under section 506(b) a creditor is entitled to add post-petition attorneys’ fees to its secured claim if the following conditions are met: (1) the creditor is over-secured; (2) the fees are reasonable; and (3) the fees are provided for in the agreement or state statute under which the claim arose. If fees al-
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Lowed by agreement or statute are found not to be reasonable, some courts allow the “unreasonable fees” to be treated as an unsecured claim. 46

This article will first address the threshold question of whether a claim for pre- and post-petition attorneys’ fees is allowable under section 502(b), followed by an analysis of cases that allow attorney fees under both sections 506(b) and 502(b), and practical suggestions to protect the right to collect attorneys’ fees.

1. Necessity of Attorney Fee Provision and Compliance with State Law

A lender, holder of a conditional sales contract, or holder of other evidence of indebtedness must provide in its agreement with the debtor for collection of attorneys’ fees in the event of default or base its claim upon a statutory right to fees before it can have an allowed claim under section 502 for pre-petition or post-petition attorneys’ fees. 48 Many states provide that before attorneys’ fees can be collected under a contract, written notice of intent to collect the fees in the event default must be provided. Furthermore, many states prescribe the amount of attorneys’ fees than can be collected, and the state courts may have a right under state law to determine the reasonableness of the fees. 49 State statutes and state court decisions provide guidance on the proper calculation of and allowance of pre-petition fees, and should always be reviewed when fees are sought or scrutinized in the bankruptcy context.

If all prerequisites to collect attorneys’ fees from a debtor have been met under state law, a creditor may seek collection of the fees and expenses in a bankruptcy case. 50 If notice of intent to collect attorneys’ fees is required under state law, notice cannot be given due to the automatic stay occurring on a bankruptcy filing; nevertheless, bankruptcy courts have allowed post-petition fees under section 506(b) to fully secured creditors. 51 However, collection of pre-petition fees will be jeopardized. In Southside, LLC v. Suntrust Bank (In re Southside, LLC), a fully secured lender was not allowed to recover pre-petition attorneys’ fees under section 502 because it did not give the debtor notice under O.C.G.A. § 13-1-11 that the debt was in default and collection would be pursued if the debt was not paid within ten days. However, the lender was allowed to recover attorneys’ fees and costs incurred post-petition because section 506, rather than state law, controlled.

Further recent examples of defective notice are found in Windmill Run Associates v. Fannie Mae (In re Windmill Run Associates) where the bankruptcy court considered the debtor’s objection to allowance of attorneys’ fees and various expenses of Fannie Mae. The court disallowed all pre-petition attorney fees because all required parties were not notified of the debtor’s default, and the 30 day cure period did not run before legal action was taken by Fannie Mae. Following an interesting analysis of work performed by lender’s counsel, post-petition fees were reduced but allowed in an amount found reasonable. In In re Parker, the lender’s failure to inform the debtor in a default notice that he could pay the balance due and
thus avoid attorney fees was fatal under North Carolina law to the lender’s right to collect pre-petition attorneys’ fees, but the court allowed reasonable post-petition fees.\(^{58}\)

It is advisable to include broad language regarding what services are covered by an attorneys’ fee provision. A provision wherein the borrower agreed to pay upon demand all of a lender’s costs and expenses of collection, including lender’s attorneys’ fees and expenses incurred to enforce the loan documents, was found to allow the lender to recover under section 506(b) fees incurred in defending an avoidance action brought by a trustee against the lender.\(^{59}\) Typically fee provisions relate to recovery of costs of collection but adding language to protect the lender in the event of a bankruptcy filing, including a lien challenge or avoidance action, would be advisable.

The Eighth Circuit Bankruptcy Appellate Panel has held that if various loan documents are used to obtain a confession of judgment against a party, and that party files bankruptcy, the loan documents containing the agreement for attorneys’ fees support the right of an oversecured judgment creditor to add reasonable attorneys’ fees to its claim under section 506(b).\(^{60}\) The judgment provides a lien but does not terminate the right to attorneys’ fees.

2. Recent Decisions on Reasonableness under Section 506

The allowance of post-petition fees and costs under section 506(b) to a fully secured creditor is governed by the bankruptcy court determination of what amount is reasonable under federal law. The creditor has the burden of proving the fees it seeks are reasonable.\(^{61}\) There are many cases addressing the reasonableness of fees and expenses allowable to secured creditors and each contains specific facts underlying the decision of the bankruptcy court. The factors most often considered include the lodestar analysis\(^{62}\) and 12 factors set out in \textit{Johnson v. Georgia Highway Exp., Inc.}\(^{63}\)

If lender’s counsel engages in overzealous advocacy, the bankruptcy court may disallow the fees. For example, if a secured lender is clearly retaliating against a debtor its fees will most likely be reduced as reflected in the recent case of \textit{In re Windmill Run Associates, Ltd.}\(^{64}\) The bankruptcy court determined that the lender had acted in bad faith during part of the case to increase its leverage, and thus some of its counsel fees were disallowed as a “radical cost increase” after a “warlike response.”\(^{65}\) Also, the court did not allow default interest to Fannie Mae because the lender acted in bad faith when it attempted to acquire property that secured its claim and did not face any significant risk of nonpayment.\(^{66}\)

Similarly, if an oversecured creditor is using its position for “ulterior motives,” its attorneys’ fees may be disallowed. In \textit{In re Reorganized Lake Diamond Assocs., LLC},\(^{67}\) the court denied attorneys’ fees and costs incurred in connection with an oversecured creditor’s post-petition purchase of its secured claim and subsequent attempts to acquire the debtor.\(^{68}\) Such actions of a lender which go beyond collection and protection of its right to payment are at great risk of disallowance.
The type and value of legal services considered reasonable can vary widely depending upon the dynamics of a case. In *In re Coastal Realty Investments, Inc.*, 69 the bankruptcy court found that proper state notice of attorneys’ fees was given, and a 15% attorneys’ fee award was provided for under the terms of the loan documents for pre- and post-petition fees. The amount ultimately allowed for post-petition fees under section 506(b) was approximately 10% of the balance due the lender, with the balance allowed as an unsecured claim.70 The court allowed the lender to recover for work not directly related to the debtor’s case, including fees incurred in pursuing guarantors in state court and defending an adversary proceeding brought by the guarantors in the bankruptcy case.

Under section 506(b) bankruptcy courts can allow fees and expenses that greatly exceed what would be recoverable under state law in relation to the principal balance due the lender. In *Sundale, Ltd.*,71 the lender sought reimbursement for $3.8 million dollars in fees and costs incurred in seeking collection of a fully secured $5 million dollar claim as of the petition date. The court examined the lender’s action for “overkill,” but found that all of the major battles in the main case and an adversary proceeding that was appealed were necessary and reasonable in the enforcement of the lender’s claim.72 The lender was allowed $3.2 million in fees and expenses.73 The court in *Shree Mahalaxmi* allowed post-petition fees in the amount of $335,000 related to a principal balance due of $618,870 after a thorough analysis of work done by local and lead counsel.74 Again, in that case, work performed in a state court guarantor action was allowed. Also, fees billed for an unsuccessful effort to obtain pre-petition default interest were allowed, and the court noted that section 506(b) does not differentiate between when counsel wins or loses, but rather whether the fees and costs are reasonable.75

A bankruptcy judge has the unique vantage point of observing all matters in the case, and is well positioned to determine whether the lender is acting reasonably or is being overly aggressive. In fact, a bankruptcy court has recently stated that “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 justified by the economics of the situation and necessary to preserve the creditor’s interest in light of the legal issues involved.”76 Thus, it is best for counsel to a lender to advise the lender holding a fully secured claim that an overly emotional, non-strategic approach to a case could result in costs for the lender that are not paid in full under section 506(b). Lenders do not have a “blank check” to have their counsel wage war on a debtor.

When an objection is raised to fees sought by a creditor under section 506(b), the fees incurred in defending the fee request under section 506(b) are allowable in the opinion of the Western District of Texas Bankruptcy Court despite the recent Supreme Court holding in *Baker Botts L.L.P. v. ASARCO LLC*.77 The Supreme Court ruled that fees incurred by professionals employed under section 327(a) in defending objections to fees under section 330 are not compensable because the work is not of benefit to or neces-
sary for the administration of the estate. The bankruptcy court held that requirements of section 330 are not applicable to the work of counsel for a creditor under section 506(b), and thus reimbursement for defense of a fee application is allowable. 78

3. Bankruptcy Jurisdiction to Rule on Fees under Section 506(b)

After the automatic stay is lifted or property is abandoned, does the bankruptcy court retain jurisdiction to rule upon the allowance of attorneys’ fees? The surprising answer is yes (at least in some courts). In 804 Congress, L.L.C v. Wells Fargo Bank N.A. (In re 804 Congress, L.L.C.), the Court of Appeals for the Fifth Circuit affirmed that the section 506(b) reasonableness standard applies to an over-secured lender’s pre- and post- petition legal fees following a post-petition non-judicial foreclosure sale. 79

After a lender succeeded in getting relief from stay to proceed with a non-judicial foreclosure under state law, $4.355 million was bid at the sale, and this sum was approximately $400,000 more than the lender was due on the note. When the court was made aware of the sale results, it exercised jurisdiction over all of the proceeds, and the lender and trustee were required to file claims for amounts due including attorneys’ fees and costs. The lender steadfastly maintained that after the stay was lifted, the bankruptcy court did not have jurisdiction over the proceeds, and in keeping with that philosophy, lender’s counsel did not file an application for fees. The lender’s claim for attorneys’ fees was denied even though it was clear some services were rendered and the fees were paid by the lender. 80

In an appeal by the lender, 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 the lender’s legal fees under section 506(b) when lender’s counsel provided no evidence to show the reasonableness of the fees. The Fifth Circuit ruled that the bankruptcy court retained jurisdiction after lifting the stay because lifting the automatic stay to allow the lender to foreclose was not tantamount to an abandonment of property. 81

On remand, the bankruptcy court considered whether the fees could be allowed under section 502(b) as an unsecured claim. This required the bankruptcy court to examine the fees under the requirements of Texas law, which required that the fees be reasonable in amount. Again, the failure of the lender to provide any substantiation of the amount sought as fees resulted in total disallowance of the fees under section 502(b). 82

Interestingly, the issue of applicability of section 506(b) following abandonment of collateral arose in In re Ormond. 83 In March 2015, the United States Bankruptcy Court for the Eastern District of North Carolina found that it could determine reasonableness of fees even after abandonment of the debtor’s real property because the land was still property of the debtor over which the court had exclusive jurisdiction pursuant to 28 U.S.C.A. § 1334(e)(1). 84 The Court also noted that the amount due the lender would
affect other creditors, especially the second lien holder and unsecured claimants. The lender was required to produce its counsel’s time records to substantiate the amount of fees billed, and it could not rely on North Carolina law to recover its fees.85

The lesson from these cases is that lenders’ counsel should always document their fees and expenses in a manner that will permit them to file fee applications with the requisite detail to support the reasonableness of the fees and costs if the need arises. In addition, where relief from stay is granted after evidence of lack of equity is provided, lenders should consider including a provision in stay orders stating that the proceeds from a foreclosure are not subject to the claims of the bankruptcy estate or the debtor. If the foreclosure sale yields more sales proceeds than anticipated, such a provision might avoid any need for court approval of lender’s attorneys’ fees.86

D. Unsecured Claim for Fees Found Unreasonable under Section 506?

If the bankruptcy court determines, where the lender is fully secured, that all or part of a lender’s attorney fees are not reasonable under section 506(b), are the fees allowable in the bankruptcy case as an unsecured claim? The leading case on this issue is the decision of the Eleventh Circuit Court of Appeals in Welzel v. Advocate Realty Investments, LLC (In re Welzel),87 which provides an excellent analysis of the interplay of sections 502(b) and 506(b). The court first analyzed whether the lender’s claim for attorneys’ fees was allowed under section 502(b). The lender sought an allowance of attorneys’ fees under the loan documents and Georgia law in the amount of 15% of the principal and interest owing on the note. The debtor argued that the loan documents were ambiguous and asked the court to invalidate the 15% provision and limit the claim to “reasonable attorneys’ fees.”88 The court, however, rejected the debtor’s arguments and held that the debtor’s argument mistakenly applied the section 506(b) reasonableness standard to the issue of claims allowance under section 502.

As discussed in this article, many bankruptcy courts have held that section 506(b) is not a claim disallowance provision, but rather provides the basis for determining whether a non-bankruptcy law created obligation is allowable as part of a secured or unsecured claim in a bankruptcy case. In Welzel, the Eleventh Circuit held that once fees were allowed under section 502, their reasonableness had to be analyzed under section 506(b). This is because fees deemed reasonable constitute an secured claim, with the balance of unreasonable fees treated as an unsecured claim. The Welzel court did not distinguish between pre- and post-petition fees, and specifically noted that section 506(b) refers to “reasonable fees” without distinction as to when vested.89

The bankruptcy court for the Western District of Texas, agreed with Welzel on remand from the Fifth Circuit in In re 804 Congress, L.L.C.,90 and determined that part of the fees due a foreclosing trustee that had been found unreasonable under section 506(b) would be allowed as an unsecured claim.
under section 502(b). A similar ruling is found in In re F & G Leonard, LLC, an Eastern District of North Carolina bankruptcy decision. However, in the same district another judge disallowed such an unsecured claim. Courts are not unified on the granting undersecured creditors an unsecured claim.

E. Allowance of Attorney Fees to an Unsecured Creditor

Despite lack of clarity in the Code, there is support for allowance of pre- and post-petition fees to unsecured creditors. In Travelers Casualty. and Surety. Co. of America v. Pacific Gas and Elec. Co., the Supreme Court held “that the Bankruptcy Code did not categorically disallow contractual claims for attorneys’ fees incurred in litigating issues of federal bankruptcy law, for such a rule found no support in (1) § 502(b) of the Code (11 U.S.C.A. § 502(b)), under which a bankruptcy court had to allow a creditor’s claim except to the extent that the claim implicated any of nine enumerated exceptions; or (2) elsewhere in the Code.” Some lower courts have latched on to the fact the Supreme Court declined to express an opinion with regard to whether other principles of bankruptcy law might provide a basis for disallowing Travelers’ claim for attorney’s fees. However, the Court of Appeals for the Second Circuit held in In re United Merchants and Mfrs., Inc. that section 506(b) imposes no bar to an unsecured creditor’s ability to recover post-petition attorneys’ fees as a contingent right.

Before and after the Supreme Court’s Travelers decision, bankruptcy courts have been divided on the question of whether an unsecured creditor is entitled to include contract-based attorneys’ fees incurred post-petition, in a prepetition claim. In 2009, the Ninth Circuit fully considered the issue in SNTL Corp. v. Ctr. Ins. Co. (In re SNTL Corp.), and compared the decisions in Qmect, Inc. v. Burlingame Capital Partners II, LP (In re Qmect, Inc.) of the North District of California that allowed attorney fees, to the decision in n re Electric Machinery Enterprises, Inc., a Middle District of Florida case that disallowed them. The Ninth Circuit agreed with the Qmect court that claims for post-petition attorneys’ fees cannot be disallowed simply because the claim of the creditor is unsecured.

To reach this conclusion, the Ninth Circuit noted that those courts disallowing attorney’s fees to unsecured creditors relied on the language of section 506(b), that “to the extent” a claim is oversecured, and “there shall be allowed” interest and fees, to mandate the conclusion that in all other circumstances, post-petition interest, attorneys’ fees, and charges shall not be allowed. These courts concluded that if Congress intended for unsecured creditors to receive post-petition attorneys’ fees, then it would have done so explicitly by authorizing unsecured creditors to collect fees under section 506(b). To the contrary, the Ninth Circuit was more persuaded by Qmect which observed that

If Congress, in enacting the Bankruptcy Code, had wanted to disallow claims for post-petition attorneys’ fees, the logical place for it to have done so was surely in 11 U.S.C. § 502(b). Moreover, 11 U.S.C. § 506(b) does not distinguish between pre-petition and post-petition attorneys’ fees. Thus, if 11 U.S.C.
§ 506(b) is read as an additional ground for objecting to claims, arguably, an unsecured creditor would be prohibited from including its pre-petition attorneys’ fees in its claim as well as its post-petition fees. It disagreed because this approach is inconsistent with the Bankruptcy Code’s broad definition of “claim,” which includes any right to payment, whether or not that right is contingent and unliquidated. Another argument supporting disallowance of attorney fees is the Timbers decision, in which the Supreme Court concluded that because section 506(b) permitted post-petition interest to be paid only out of an equity cushion, an undersecured creditor who had no such equity cushion, and thus fell within the general rule of disallowing post-petition interest. However, the Timbers case applied to post-petition interest, which is specifically disallowed under section 502(b)(2), whereas attorneys’ fees are not disallowed under that Code section.

In response to a public policy argument that allowing post-petition attorney’s fees would erode the equality of distribution concept for unsecured creditors, the SNTL court stated that it was the “province of Congress to correct statutory dysfunctions and to resolve difficult policy questions embedded in the statute.” Thus, the Ninth Circuit determined that the better reasoned position was to allow the unsecured creditor to include post-petition attorney fees in its claim.

Since 2008, the issue continues to arise in various courts and the Ninth Circuit’s position has not been consistently followed. Subsequent recent bankruptcy court decisions in Delaware, and New Mexico, have refused to allow post-petition attorney’s fees as part of an allowed unsecured claim. In In re Tribune Media Company, the Delaware bankruptcy court followed the arguments of In re Global Indus. Technologies, Inc. to determine that an undersecured lender was not eligible for post-petition attorneys’ fees under section 506(b). However, the Eastern District of North Carolina has allowed attorney’ fees to a wholly unsecured creditor.

F. Protecting the Right to Attorneys’ Fees When Taking Assignment of Loan Documents

When loan documents are assigned by the creditor, the buyer should consider preserving its right to collect any attorneys’ fees paid by the selling lender. In In re Gregg the debtor borrowed $8,200,000.00 from a lender secured by real property in South Carolina. The loan documents provided the lender with the right to reimbursement for reasonable attorneys’ fees and costs associated with default and collection. The lender assigned the loan documents to a purchaser, and the assignment documents stated that the total owed on the loan was principal, interest and a late charge. No attorneys’ fees due the lender were mentioned.
The chapter 11 trustee in the case objected to payment of any attorneys’ fees to the purchaser for legal fees incurred by the selling lender. The court allowed the objection and noted that when a negotiable note is transferred it generally provides the transferee with the right to enforce the note and includes all rights of the transferor at the time of the transfer. However, a party may transfer a note partially, conditionally, or with a reservation of rights, and the transfer did not include the lender’s right to recover the fees.115

Also, 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 section 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 or may seek reimbursement for its time and expenses in doing so.

The bankruptcy court for the Middle District of North Carolina recently disallowed over $500,000 in fees requested by a fully secured party that took an assignment of loans. The key basis for the disallowance was that the secured party engaged counsel, but was not billed for nor paid the fees requested under section 506(b). The attorneys billed and were paid by a third party whose relationship to the secured party was not explained by the only witness.116 This order is on appeal.

G. Conclusion

The issues involved in allowance by the bankruptcy court of default interest and attorneys’ fees are more complex than most practitioners or their lender clients realize. Lenders and their counsel must carefully follow the requirements of state law to give proper notice, and counsel must maintain detailed time records, act prudently in the protection of the lender’s interest, and investigate court precedent on allowance of default interest and attorneys’ fees. Such actions will enable counsel to protect the lender and its bargained for right to recover default interest and attorneys’ fees to the greatest extent possible.

NOTES:

4See Dvorkin Holdings, LLC, 547 B.R. 880, 898 (N.D. Ill. 2016) (ruled that contract default interest must be paid pursuant to plan in which unsecured creditors were unimpaired and equity retained its interests); but see In re Cardelucci, 285 F.3d 1231, 1235, 39 Bankr. Ct. Dec. (CRR) 110, Bankr. L. Rep. (CCH) P 78658 (9th Cir. 2002) (using the federal judgment interest rate as the “legal rate” under section 726(a)(5) in a surplus case).
5In re 785 Partners LLC, 470 B.R. at 134.
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9In re 785 Partners LLC, 470 B.R. at 131.

10In re 785 Partners LLC, 470 B.R. at 131.

11In re 785 Partners LLC, 470 B.R. at 133.


19In re Energy Future Holdings Corp., 540 B.R. at 124, citing, at its note 7, W.R. Grace, 475 B.R. at 175, for this proposition.


23See e.g., Matter of Lapiana, 909 F.2d 221, 20 Bankr. Ct. Dec. (CRR) 1391, 23 Collier Bankr. Cas. 2d (MB) 766, Bankr. L. Rep. (CCH) P 73567, 90-2 U.S. Tax Cas. (CCH) P 50436, 66 A.F.T.R.2d 90-5970 (7th Cir. 1990) (Ron Pair did not completely extinguish the bankruptcy court’s power to abate statutory pendency interest to an oversecured tax creditor; such awards remain subject to valid defenses, including equitable defenses. But § 506(b) is not an “invitation to a free-for-all equity-balancing act” and “bankruptcy judges are not empowered to dissolve rights in the name of equity.”).

In re 785 Partners, LLC. (After analyzing the equitable factors, the court awarded default rate interest. The court found no evidence of misconduct on the creditor’s part, any impact on unsecured creditors whose claims were being paid in full or any impairment of the debtor’s fresh start. While the court acknowledged a penal or coercive aspect to default rates in general, that alone was insufficient to preclude an award of default interest.) See also In re General Growth Properties, Inc., 451 B.R. 323, 328, 55 Bankr. Ct. Dec. (CRR) 6, 65 Collier Bankr. Cas. 2d (MB) 1351 (Bankr. S.D. N.Y. 2011) (Court approved award of post-petition default rate interest to oversecured creditor where debtor conceded the default rate was not a penalty, alleged no creditor misconduct and debtor’s “exceedingly solvent” status belied any harm to unsecured creditors or impairment of the debtor’s “fresh start”); In re Sultan Realty, LLC, 2012 WL 6681845 (Bankr. S.D. N.Y. 2012) (upholding 24% default rate where debtor failed to establish an equitable basis for reduction, and noting that under New York law, a default rate is an agreement to pay interest not a penalty).

See e.g., In re Deep River Warehouse, Inc., 2005 WL 1513123 (Bankr. M.D. N.C. 2005); In re Vest Associates, 217 B.R. 696 (Bankr. S.D. N.Y. 1998) (default rate of 15% deemed inordinately high in relation to nondefault rate and penal in nature); Matter of Terry Ltd. Partnership, 27 F.3d 241, 31 Collier Bankr. Cas. 2d (MB) 231, Bankr. L. Rep. (CCH) P 75933 (7th Cir. 1994) (Default rate of 3% over nondefault rate was approved where evidence showed rate was reasonable and customary. Purpose of default rate was to compensate for unforeseeable costs of default and allowance in contract of specific default related costs, such as appraisal fees did not equate to a double recovery to creditor.)


See General Elec. Capital Corp. v. Future Media Productions, Inc., 547 F.3d 956, 60 Collier Bankr. Cas. 2d (MB) 1343 (9th Cir. 2008) (The payment of an oversecured claim pursuant to a § 363 sale is not a “cure” as contemplated by § 1123, and in the absence of a cure the appropriate standard to apply is the presumption in favor of awarding the contract rate as adopted by the majority of federal courts; In re Catton, 555 B.R. 713, 62 Bankr. Ct. Dec. (CRR) 257, 76 Collier Bankr. Cas. 2d (MB) 12 (Bankr. S.D. Cal. 2016) (debtor not entitled to credit for default pendency interest paid prior to plan confirmation, where cure of default occurred not through plan, but during course of case through sale of collateral and regular loan payments.)
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40In re General Growth Properties, Inc., 451 B.R. at 327; compare In re Moody Nat’l SHS Houston H, LLC, 426 B.R. at 672 (“to the extent that there was ambiguity as to how to cure a default when Entz-White was written, that ambiguity evaporated in 1994 when § 1123(d) was added” to the Bankruptcy Code) with In re Phoenix Business Park Ltd. Partnership, 257 B.R. 517, 522, 37 Bankr. Ct. Dec. (CRR) 81 (Bankr. D. Ariz. 2001) (Entz-White remains good law in the 9th Circuit because Congress did not legislatively overrule the holding when it enacted § 1123(d)).

41In re Southland Corp., 160 F.3d at 1059 n.6; In re Sagamore Partners, Ltd., 620 Fed. Appx. 864, 867 (11th Cir. 2015).


43In re New Investments, Inc., 840 F.3d at 1142.


47Evidence of indebtedness can be a commercial real property lease, personal property lease, credit agreement, operator agreement, guaranty agreements in connection with commercial loans. See Ann M. Anderson, Attorney Fee Provisions in North Carolina Contracts, Administration of Justice Bulletin, UNC School of Government, September, 2011.

48Careful drafting of both original loan documents and modifications to those documents will help to avoid issues with the right to attorneys’ fees. In In re Monticello Realty Investments, LLC, 526 B.R. 902 (Bankr. M.D. Fla. 2015), the original promissory note contained a specific provision for the recovery of the bank’s attorneys’ fees in the event of a bankruptcy. Even though a subsequent modification did not contain such a provision, it did provide that the terms of the original loan documents would remain valid except as amended. The court found that the bank did not waive its right to recover attorneys’ fees in the bankruptcy case.

49For example, in North Carolina, N.C.G.S. 6-21.2 allows enforcement of attorney fee provisions in notes, conditional sale contracts and other evidence of indebtedness under certain circumstances. If a percentage of the balance due is set for the attorneys’ fees, then under the statute, no greater than 15% of the outstanding balance due on the note is allowed. If the note does not provide for a percentage or provides for reasonable attorney’s fees, then the statute finds that a statutory fee of 15% of the outstanding balance is allowed. The Supreme

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Court of Texas has recognized that a noteholder can be limited to reasonable attorney’s fees notwithstanding a clause in the note obligating payment of a specified percentage of the loan at attorney’s fees to the noteholder. Garcia v. Gomez, 319 S.W.3d 638, 646 (Tex. 2010).

A secured creditor should consider attaching to its proof of claim any documents that establish its satisfaction of requirements to collect fees under state law.


O.C.G.A. § 13-1-11(a)(3) requires a party seeking payment of contractual attorneys’ fees first issue a demand notice: (1) in writing; (2) to the obligated party; (3) after maturity; (4) stating that the contractual attorneys’ fees provisions will be enforced in addition to principal and interest; and (5) stating that the party has 10 days from the receipt of such notice to pay the principal and interest without the attorney fees.


Grant v. George Schumann Tire & Battery Co., 908 F.2d 874, 879, 23 Collier Bankr. Cas. 2d (MB) 708, Bankr. L. Rep. (CCH) P 73577 (11th Cir. 1990) (“In an ordinary attorney’s fee case, the court arrives at a fee by multiplying the attorney’s reasonable hourly rate by the number of hours reasonably expended. Hensley v. Eckerhart, 461 U.S. 424, 433, 103 S.Ct. 1933, 1939, 76 L.Ed.2d 40 (1983). A calculation of the reasonableness of the rates and hours usually involves consideration of the twelve Johnson factors. Id. at 434 n. 9, 103 S. Ct. at 1940 n. 9.”).

The factors set out in Johnson include: (1) time and labor required, (2) novelty and difficulty of the questions, (3) skill requisite to perform the legal service properly, (4) preclusion of other employment by the attorney due to acceptance of the case, (5) the customary fee, (6) whether fee is fixed or contingent, (7) time limitations imposed by the client or circumstances, (8) the amount involved and the results obtained, (9) undesirability of the case, (10) experience, reputation and ability of attorneys, (11) nature and length of the professional relationship with the client, and (12) awards in similar cases. See Johnson v. Georgia Highway Exp., Inc., 488 F.2d 714, 717–19, 7 Fair Empl. Prac. Cas. (BNA) 1, 7 Empl. Prac. Dec. (CCH) P 9079 (5th Cir. 1974); see In re Shree Mahalaxmi, Inc., 522 B.R. 899, 907, 60 Bankr. Ct. Dec. (CRR) 133 (Bankr. W.D. Tex. 2014).


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68In re Reorganized Lake Diamond Assoc., LLC, 367 B.R. at 869.


72In Sundale, Ltd., 483 B.R. at 33.

73In Sundale, Ltd., 483 B.R. at 35.

74In re Shree Mahalaxmi, Inc. 522 B.R. at 917.

75In re Shree Mahalaxmi, Inc. 522 B.R. at 911.


78In re Shree Mahalaxmi, Inc., 522 B.R. at 914.


83In re Ormond, 2015 WL 1000218 (Bankr. E.D. N.C. 2015)

84In re Ormond, 2015 WL 1000218, at *3 (Bankr. E.D. N.C. 2015). But see In re Home and Hearth Plano Parkway, L.P., 320 B.R. 596, 603, 44 Bankr. Ct. Dec. (CRR) 7, 53 Collier Bankr. Cas. 2d (MB) 527 (Bankr. N.D. Tex. 2004) (“The Debtor’s interest in property is determined by reference to state law); Butner v. U.S., 440 U.S. 48, 55, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481, Bankr. L. Rep. (CCH) P 67046 (1979). Here, the Debtor owned the Hotel when the Case commenced; thus, the Hotel was property of the estate. 11 U.S.C.A. § 541. Section 554(d) of the Bankruptcy Code provides that unless the court orders otherwise, property of the estate that is not abandoned or administered in the Case remains property of the estate.” The order modifying the automatic stay specifically retains the right of the trustee to receive the excess proceeds.; In re Solid Rock Development Corp., Inc., 481 B.R. 221, 226 (Bankr. N.D. Ga. 2012) (“The foreclosure bid was a credit bid and does not necessarily reflect the extent to which the creditor recovered fees in excess of those allowable under Section 506(b). Consequently, the Court will schedule an evidentiary hearing as to the value of the Property and the amount of allowable fees to determine if the Defendant received property in excess of its allowable claim (principal, interest, and actual, reasonable attorney’s fees.”)


86Home & Hearth Plano Parkway, L.P. v. LaSalle Bank, N.A. (In re Home & Hearth Plano Parkway, L.P.) at 604 (The order denying confirmation and lifting stay allowed foreclosure under the terms of the Deed of Trust, and pursuit of any state law remedies under the
loan documents under applicable law, to the exclusion of the Debtor and all other creditors. The court upheld the order after the lender credit bid in excess of its bankruptcy claim amount).

88 Welzel v. Advocate Realty Investments, LLC (In re Welzel), 275 F.3d at 1312–1314.
89 Welzel v. Advocate Realty Investments, LLC (In re Welzel), 275 F.3d at *1314.
In re 804 Congress, L.L.C., 529 B.R. at 228.
In re F & G Leonard, LLC, 2011 WL 5909463, at *2 (Bankr. E.D. N.C. 2011) (“Section 506(b) is not a disallowance statute . . . It merely allows an oversecured creditor to include reasonable attorneys’ fees as part of its secured claim. In the event that the attorneys’ fees sought are allowable under state law, but found to be unreasonable under § 506(b), the fees may be recovered as an unsecured claim.”).

89 In re Croatan Surf Club, LLC, 2012 WL 1906386, at *7 (Bankr. E.D. N.C. 2012) (“The court need not 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 RBA is not eligible for post-petition attorneys’ fees under § 506(b). The court finds that no unsecured claim is created for the post-petition fees sought; rather, the fees are disallowed. Section 506(b) provides a limited substantive right to post-petition fees. If such fees are the Code other than 506(b), that permits allowance of post-petition fees.”)

90 Travelers, 549 U.S. at 454.
93 United Merchs. & Mfrs., Inv. v. Equitable Life Assurance Soc’y of the U.S., 674 F.2d at 138; Ogle v. Fid. & Deposit Co. of Md., 586 F.3d at 147.
95 In re SNTL Corp., 571 F.3d 826, Bankr. L. Rep. (CCH) P 81515 (9th Cir. 2009).
98 Qmect, Inc., 368 B.R. at 885.
99 SNTL Corp. v. Ctr. Ins. Co. (In re SNTL Corp), 571 F3d. at 843.
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106Timbers, 484 U.S. 365.
113In re Holden, 491 B.R. at 738.
115In re Gregg, 528 B.R. at 653. See 3 S.C. Code Ann. § 36-3-203(b)