

# **Attorneys' Fees Provisions in Nonrecourse Loans and in Debtor Bankruptcy Proceedings: Are They Enforceable?**

By John C. Murray

## **Nonrecourse Loans - The Aozora Bank Decision**

In an interesting postscript to *Nippon Credit Bank, Ltd. v. 1333 North California Boulevard*, 86 Cal. App. 4th 486 (2001), the California appellate court, in *Aozora Bank, Ltd. v. 1333 North California Boulevard*, 119 Cal. App. 4th 1291 (2004), ruled that the bank lender (Aozora Bank Ltd., formerly known as The Nippon Credit Bank, Ltd.), which was the beneficiary of the court's ruling in the *Nippon Credit* case that the borrower partnership and its general and managing partners were guilty of the tort of bad-faith waste for failure to pay real estate taxes while the nonrecourse mortgage was delinquent, was not entitled to attorneys' fees under the contractual language in the loan documents. See John C. Murray, *Nonpayment of Taxes as Tortious Waste in Nonrecourse Mortgage Loans*, 19 CAL. REAL PROP. J. 22 (Spring 2001) (reviewing case law, including *Nippon Credit*, supra, finding that mortgagor's nonpayment of real estate taxes constitutes actionable waste under contractual or tort theory).

The jury at the trial court level had found the defendants liable for approximately \$395,000 in compensatory damages and \$8,333,333 in punitive damages. But the trial court remitted the amount of punitive damages to \$1.6 million. The appellate court (in an unpublished portion of the opinion) upheld the remittur of punitive damages and the order for new trial on the amount of punitive damages only. At the second trial, in which the jury awarded no punitive damages to the bank, the bank moved for an award for the attorneys' fees it incurred in the case, in the amount of approximately \$1,434,000. The trial court approved this request by the bank, which included a 1.5 multiplier for "the complex and cutting edge nature of the issues litigated." The borrower then appealed this ruling to the appellate court.

The appellate court reversed the trial court's determination that the bank was entitled to attorneys' fees under the contractual language in the loan documents. The court first noted that attorneys' fees are not generally available to prevailing parties in tort actions, citing applicable California statutes and case law. According to the court, "Since there is no statutory or other legal authority for an attorney fee award in this instance, Bank's entitlement to fees hinges entirely on the terms of the parties' contract." *Id.* at \*3.

Turning to the contractual language, the court rejected the bank's argument that the borrower was liable under the general attorneys' fee provisions contained in the note and mortgage. According to the court, "even if those provisions extended to the fees in question, the Partnership would not be liable for them unless such liability was excepted from the nonrecourse feature of the note and deed of trust," i.e., if the carveouts did not expressly include liability for attorneys' fees, they would only be recoverable from the real estate collateral. *Id.* at \*4. The applicable nonrecourse carveout in the note and deed

of trust stated that, "nor shall such limitation of liability apply if and to the extent that [Borrower/Trustor] . . . commits fraud, material representation or waste." The court seized on this language to find the following reasons to reject the trial court's determination that it was broad enough to make the borrower partnership liable for attorneys' fees as well as waste damages: (1) the carveout did not specifically refer to attorneys' fees, and would not be implied because attorneys' fees generally are not awarded in tort actions; (2) given the importance of this issue, which the court noted is one of the key concerns of lenders when negotiating nonrecourse carveouts, "it is unlikely that the carve-out would be silent on attorneys' fees if they were intended to be included" (the court noted the uncontradicted testimony of an expert who testified that carveouts were "always expressed, and never implied"), *Id.* at \*7, and (3) because the carveout only applied "if and to the extent" that waste was committed, this undercut the bank's argument that the carveout entirely negated the nonrecourse aspect of the agreement when waste is committed. The court summarized by stating that, "the most reasonable reading of the agreement is that the waste carve-out does not implicitly include attorneys' fees for prosecuting a waste action. As a consequence, recovery of these fees from the Partnership is barred by the nonrecourse provisions of the note and deed of trust." *Id.* at \*8.

The appellate court also dismissed the bank's argument that if it were precluded from obtaining attorneys' fees, it would "void the general purpose" of the general attorneys' fees provisions in the note and mortgage but the borrower would be able to invoke the attorneys' fees clause against the lender, thus violating the California statutory provision (CAL. CIV. CODE SEC. 1717) that makes attorneys' fees clauses reciprocal. The court noted that because the partnership borrower was not the prevailing party in the case, it need not decide the issue of reciprocity, and that the bank still could benefit from the attorneys' fees provisions of the note and deed of trust even though the loan was nonrecourse, because it could recover such fees from the mortgage security and add them to the amount required to reinstate the loan or add them to the amount of a credit bid at a foreclosure sale. The court stated that, "If bank wanted additional recourse against the Partnership personally it should have negotiated for an attorney fee carve-out in the loan documents." *Id.* at \*10.

Finally, the appellate court rejected the bank's argument that it was entitled to attorneys' fees as well as waste damages under the reasoning of the court's prior ruling in this case. The appellate court noted that the bank had sued in tort, not under the contract, and had never mentioned the waste carveout. The court stated that, "our analysis was focused on whether the evidence in the first trial supported a bad faith finding," and "[w]e had no occasion in the prior appeal to consider the nonrecourse provisions of the note here - they plainly include a carve-out for waste damages, and no issue was made of them." *Id.* at \*11.

## Discussion

This decision unveils yet another trap for the unwary, and is a cautionary tale and "wake-up" call for lenders not to be careless when drafting attorneys' fees provisions in commercial loan documents that contain nonrecourse provisions with specific carveouts. The lender easily could have prevailed in this case -- and picked up another \$1,434,000 -- if it had merely inserted the "magic words" in the carveout language of the nonrecourse provision. The appellate court even set forth the "roadmap" to follow in a footnote, where it referred to the "waste carve-out exemplar" in a 1999 PLI publication entitled *What Borrowers and Lenders Need to Know Now*. The court cited the following language from this publication, which provides that the waste carveout provision should cover "all loss, cost (including [reasonable] attorneys' fees and expenses), expense, claim, liability or damage incurred by Mortgagee as a result of waste of the Mortgaged Premises, which [materially] reduces the value of the Premises." *Id.* at \*6-7, n.2.

Attorneys' fees provisions in loan documents generally are not favored by courts (as demonstrated by the *Aozora* case), and such clauses must be specific, conspicuous, and comprehensive or they will not be enforced. Lenders should also be cautioned to provide, in a modification agreement, that all rights under the original mortgage are preserved, and specifically provide in the modification agreement for the right to collect attorneys' fees even if the original loan documents contain an attorneys' fees provision. Otherwise, if the lender sues based on provisions in the modification agreement, and it doesn't contain a specific right to attorneys' fees, the lender may not get them. *See Wheeling Trust & Savings v. Citizens National Bank*, 142 Ill.App.3d 333 (1986), in which the borrower brought an action against the bank lender for a declaratory judgment that language in the Extension Agreement executed by the parties, which provided an interest rate of 6% over prime, but 5% over prime if no default in note and payments timely made, was an unenforceable penalty. The court held that the interest rate provision was not a penalty before maturity, but also held that the bank was not entitled to attorneys' fees (which the bank had petitioned for). The mortgage contained a covenant that the borrower would pay for any expenses and attorneys' fees incurred by the bank in "any action or proceeding to protect its security or in which it was made a defendant by reason of its mortgage". The bank argued that the language referred to "any proceeding," not just proceedings enforcing its security. The Extension Agreement specifically referenced the original mortgage and provided that it secured the Extension Agreement.

The court nevertheless reasoned that the action was brought in connection with the interest rate provided for in the Extension Agreement, which was a document separate from the mortgage. (The Extension Agreement itself made no provision for payment of attorneys' fees, nor did the bank contend that the note so provided.) The court ruled that contractual agreements for payment of attorneys' fees must be strictly construed, and must be provided for by "specific terms of the mortgage". The court acknowledged that the intention of the parties should control, but stated that in declaratory actions, the underlying action is to declare rights, not to enforce mortgage obligations, and thus attorneys' fees for actions "relating to enforcement of mortgage" are uncollectible. The moral of this decision: The intention of the parties is controlling, so make certain (in an

abundance of caution) to insert a specific clause for attorneys' fees in modification agreements, and don't limit collection to impairment of the security or enforcement of the obligations of the borrower under the mortgage. (It may be wise to refer specifically, without limitation, to declaratory actions and suits to quiet title, or "actions to determine rights of parties or any other actions or proceedings whatsoever arising out of or in connection with the mortgage, as hereby modified".)

### **Enforceability of Attorneys' Fees Provisions in Bankruptcy Proceedings**

Section 506(b) of the Bankruptcy Code permits a secured creditor, to the extent that its claim is oversecured, to collect interest on such claim and any reasonable fees (including attorneys' fees, costs, and charges) that are provided for in the loan documents. *See, e.g., In re Foertsch*, 167 B.R. 555, 562 (Bankr. D.N.D. 1994) (holding, in context of request for recovery of attorneys' fees, that in order to recover "fees, costs and charges" under § 506(b), creditor must establish: (1) that it is oversecured in excess of the amount requested; (2) that the amount requested is reasonable; and (3) that the agreement giving rise to the claim provides for recovery of the fee, cost or charge requested); *In re Udhus*, 218 B.R. 513, 517 (9<sup>th</sup> Cir. B.A.P. 1998) (same, with respect to claim by creditor for "administrative costs"); *In re Direct Transit, Inc.*, 226 B.R. 198, 201, 203 (8<sup>th</sup> Cir. B.A.P. 1998) (ruling that § 506(b) permits a claim for additional charges if the claim is oversecured, the charge is provided for in the agreement, and it is reasonable; the court also held that the charge must be enforceable under state law and stated that "[t]he fact that a charge is enforceable under state law is at least indicative of its reasonableness under the Bankruptcy Code"); *In re Hyer*, 171 B.R. 67, 69 (Bankr. W.D. Mo. 2004) (holding that oversecured creditor is entitled to enforce valid contractual obligation for payment of attorneys' fees and that § 506(b) applies "whether the attorneys' fees were incurred before or after the filing of the bankruptcy petition"; and stating further that § "506(b) allows an oversecured creditor to recover attorney fees if they are provided in the security agreement, notwithstanding Kansas law")

The oversecured creditor generally can collect attorneys' fees even if applicable state law prohibits the collection of such fees by the creditor. *See, e.g., In re Hyer*, 171 B.R. 67, 69 (Bankr. W.D. Mo. 2004) (holding that oversecured creditor is entitled to enforce valid contractual obligation for payment of attorneys' fees and that § 506(b) applies "whether the attorneys' fees were incurred before or after the filing of the bankruptcy petition"; and stating further that § "506(b) allows an oversecured creditor to recover attorney fees if they are provided in the security agreement, notwithstanding Kansas law"); *In re Schriock Const., Inc.*, 104 F.3d 200, 203 (8<sup>th</sup> Cir. 1997) (holding that attorneys' fees provisions in loan documents are enforceable in bankruptcy even though state law prohibits them).

Another issue that bankruptcy courts wrestle with is whether the "reasonableness" of the charges under § 506(b) is determined by state or federal law – or both. *See, e.g., In re Dixon*, 228 B.R. 166, 177 (Bankr. W.D. Va. 1998) ("[t]he reasonableness of charges under § 506(b) is determined by reference to the relevant state contract law"). *But see In re 268 Ltd.*, 789 F.2d 674, 676-77 (9<sup>th</sup> Cir. 1986) (applying single federal standard of "reasonableness" with respect to issue of whether an attorneys' fees provision is allowable under § 506(b)); *In re Hudson Shipbuilders*, 794 F.2d 1051, 1058 (5<sup>th</sup> Cir. 1986) (holding that fees otherwise enforceable under state law were still subject to § 506(b)'s requirement that fees be "reasonable"); *In re Weitzel*, 275 F.3d

1308, 1316-17 (11<sup>th</sup> Cir. 2001) (court determined that provision for liquidated attorneys fees of 15% of outstanding debt was unreasonable where actual fees were significantly less; “unreasonable” portion would be treated as unsecured claim); *In re American Metals Corp.*, 31 B.R. 229, 234 (Bankr. D. Kansas 1983) (same); *In re Hyer*, 171 B.R. 67, 70-71 (Bankr. D. Mo. 1994 (same)).

Bankruptcy Courts also have reached conflicting results with respect to the issue of whether § 506(b) applies only to post-petition (as opposed to pre-petition and post-petition) fees and charges. *See, e.g., In re Nunez*, 317 B.R. 666, 670 (Bankr. D. Pa. 2004) (“We hold that section 506(b) applies only to post-petition interest, fees and costs sought as part of a secured claim. Quite simply, interest, fees and costs arising pre-petition are already a part of a secured creditor's proof of claim in the first instance, rendering section 506(b) inapplicable”). *Cf. Laxa v. United States (In re Laxa)*, 312 B.R. 394, 398 (D. Ariz. 2003) (“While post-petition charges, including penalties, may be included in a secured claim only as authorized by section 506(b), pre-petition charges, including penalties, are properly included as part of the secured claim” (citations omitted)). *See also In re Leatherland Corp.*, 302 B.R. 250, 256-57 (Bankr. D. Ohio 2003) (“Even though they all assert they are interpreting the plain meaning of the statute . . . courts have arrived at differing conclusions as to whether § 506(b) applies to prepetition as well as to postpetition fees, costs and charges” (citations omitted)).

Lenders should be careful to request specifically, in state foreclosure proceedings, that attorneys’ fees and other charges and fees (such as a prepayment premium) provided for in the note and/or mortgage be specifically included in the foreclosure judgment so that bankruptcy courts will permit collection of such fees if the mortgagor subsequently files a bankruptcy proceeding. *See, e.g., In re McClung* (“If [the lender] wished to assert its right, under the note and mortgage that were the subject of the suit, to a prepayment penalty, it was required to raise the issue in the foreclosure proceeding it commenced in state court, or be forever barred.” *Id.* at \*12).

Another issue that has been litigated (with conflicting results) is whether the Bankruptcy Code disallows contract-based claims for attorneys’ fees based solely on the fact that the fees at issue were incurred litigating issues of bankruptcy law. The U.S. Supreme Court, in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 127 S.Ct. 1199 (2007), settled this issue by concluding that it does not. Prior to the bankruptcy proceedings in this case, Travelers Casualty & Surety Co. of America (“Travelers”), a creditor of the debtor, had issued a surety bond on the debtor’s behalf guaranteeing the debtor’s payment of state worker’s compensation benefit. Travelers filed a claim in the debtor’s subsequent bankruptcy proceeding to protect itself in the event of the debtor’s future default of payment of the workers’ compensation benefits. The bankruptcy court, the U.S. District Court, and the Ninth Circuit Court of Appeals all denied Travelers’ application for work done negotiating the language in the debtor’s post-petition reorganization plan and disclosure statement that provided for Travelers’ right of indemnification and indemnity in the event of default. But the U.S. Supreme Court held that Travelers was not precluded from filing an unsecured claim for its contractual attorneys’ fees, merely by virtue of the fact that the fees sought had been incurred in litigating issues of federal bankruptcy law.

This decision by the Supreme Court abrogated a prior holding by the Ninth Circuit, *In re Fobian*, 951 F.2d 1149, which had held that where the ability to recover attorneys' fees was basically one interpreting federal bankruptcy law, attorneys' fees could not be recovered even though the dispute arose out of a contract containing a provision for the recovery of such fees. This rule (called the "*Fobian* rule") was contrary to the rule applied by the Fourth Circuit Court of Appeals in *In re Shangri-La, Inc.*, 167 F.3d 843, 848-49 (C.A.4 1999), and the Supreme Court therefore granted certiorari in the *Travelers Casualty & Surety Co. case* to resolve the conflict.

The Supreme Court acknowledged that generally the "American Rule" does not award attorneys' fees to the winner of litigation, but held that the rule does not apply when where the parties have entered into an enforceable contract allocating attorneys' fees. The Supreme Court stated that the ability to recover attorneys' fees was basically one of state law and that "unless some federal interest requires a different result, there is no reason why such interests should be analyzed any differently simply because an interested party is involved in a bankruptcy proceeding." *Id.* at 1205 (quoting *Butner v. United States*, 440 U.S. 48, 57 (1999)). The court also found that there was nothing in the Bankruptcy Code that supported the *Fobian* rule and that the Bankruptcy Code simply directs bankruptcy courts to determine whether applicable state law would permit the recovery of attorneys' fees and to apply that same result to disputes in bankruptcy proceedings. As a result of the Supreme Court's ruling, a creditor having a legitimate claim can now safely include attorneys' fees (assuming the contract between the parties allows such fees) as part of its bankruptcy claim whether or not the fees arise out of litigation involving issues of federal bankruptcy law (but the resultant increase in the amount of the claim will not alter the relative priority or ultimate collectability of the claim).

Interestingly, the Supreme Court refused to consider the debtor's argument that § 506(b) of the Bankruptcy Code disallows unsecured claims for contractual attorneys' fees where, as in this case, the creditor's entire claim was unsecured. (As noted earlier, § 506(b) authorizes claims for contractual attorneys' fees to the extent the creditor is oversecured, but disallows such claims to the extent the creditor is either not oversecured or completely unsecured.) The court stated that the debtor had not raised or addressed this argument in the courts below and that the debtor "has failed to identify any circumstances that would warrant an exception to that rule in this case." *Id.* at 1207. The court further stated that in this particular case "[w]e granted certiorari to resolve a conflict among the lower courts regarding the *Fobian* rule, which is analytically distinct from, and fundamentally at odds with, [the debtor's] reading of § 506." *Id.* The court reasoned that such a reading of § 506 "would prohibit all unsecured creditors from recovering contractual postpetition attorneys' fees in bankruptcy proceedings – even if those fees were incurred while litigating issues of state law." *Id.* at n. 4. The court was careful, however, to state that "[w]e conclude only that the Court of Appeals erred in disallowing that claim based on the fact that the fees at issue were incurred litigating issues of bankruptcy law." *Id.* at 1208.