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Secured Creditors Beware in Bankruptcy Proceedings! Your Loan Provisions Can and Will be Used to Pay Debtor's Counsel's Attorney's Fees

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BACKGROUND AND HOLDING

If bankruptcy filings by your borrowers already result in unacceptable loan losses and write offs, the case of *In re Penrod*, No. 13-16097, 2015 WL 5730425 (9th Cir. Oct. 1, 2015) is going to make it a lot worse.

Simply stated, the primary impact of this case is that if you challenge a debtor/borrower's rights in a bankruptcy proceeding, and you lose, and you have a provision in your contract that awards you attorney's fees, the Debtor gets to collect the fees. At first blush, this does not sound unfair, but when you unravel the implications, they are staggering.

> **Penrod *now 'ups the ante' significantly by allowing the debtor the right to collect the fees incurred in defending against the creditor's attempts to settle rights under bankruptcy and protect its security.***

In many instances, a creditor in bankruptcy will challenge or object to the value a debtor places on its collateral or to the rights of a debtor to retain the collateral. This can be done in the context of an objection to a plan, a motion to value a claim, a motion for relief from stay, a dispute over rights to use cash collateral, or claims raised in adversary proceedings. In most instances, the creditor can recoup its fees expended in doing so if there is an allowed claim and there is equity to support the claim (See 11 USC § 506(a)). However, unless the Debtor is able to assert the right to payment of its fees as an administrative claim (from the assets of the estate in most instances), the Debtor has little recourse. The *Penrod* case changes things dramatically. Please examine the facts leading to the award of fees to the debtor and you will see why.

In *Penrod*, the lender objected to a Chapter 13 plan, asserting that its vehicle loan should be fully secured because it was a purchase-money loan.[1] The amount at issue was the difference between the actual secured value of the vehicle ($19k) and the loan balance ($26k). The creditor lost (reasons for the decision not discussed in this article) and the case was appealed on two levels (BAP, and 9th Cir. Court of Appeals). The creditor lost on appeal and the debtor sought to recover **$245k in fees**. The debtor won.

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The debtor argued that California Civil Code § 1717 transmutes fee provisions in lender loan documents to allow the debtor as well as the lender to recover attorney's fees if the debtor wins. Previously, federal courts held that an action to enforce rights under federal statutes i.e. to object to plans, bring motions for relief from stay etc. were not actions on a contract under state law and subject to California Civil Code § 1717, but were actions on federal statutes, so that the Debtor could not claim to be a prevailing party (See *In re Penrod*, at *4 (9th Cir. Oct. 1, 2015). The Court in *Penrod* overturned this interpretation, citing a prior Supreme Court Ruling in 2007 [2] and held that litigation in bankruptcy matters was not exempted from California fee shifting statutes (*In re Penrod*, at *4).

Practically speaking, this is "mind numbing". Disputes over valuation happen all the time in bankruptcy. It is part of the "bankruptcy dance" that debtors will "engineer valuations to suit their goals, often in response to the rise and fall of real estate values. Creditors respond. In auto cases, it is always a "moving target" to pin down the condition of a rapidly depreciating asset and the retail or wholesale value. Adding to the mix the need to enforce specially allowed rights protecting either purchase money-auto lenders, or real estate loans solely secured by the debtor's principal residence or a creditor's rights to remain fully secured under an 1111b election, and you have an ongoing need to settle valuation issues so that the Debtor can obtain an opportunity to repay the adjusted value and to proceed with rights allowed under bankruptcy law. In many if not most instances, bankruptcy results in immediate losses to the creditor on auto loans and in the absence of equity, on real estate secured loans. *Penrod* now "ups the ante" significantly by allowing the debtor the right to collect the fees incurred in defending against the creditor's attempts to settle rights under bankruptcy and protect its security. Please do the math in *Penrod*. The creditor tried to protect $7k in equity (under a legitimate legal theory) and was required to pay $245k! Not all cases will have such a draconian result. However, the "chilling effect" is real and immediate.

PRACTICAL CONSIDERATIONS

There is no easy answer to this question. While lenders want the right to collect fees if they prevail, collecting them against a debtor in bankruptcy is often a pointless effort. However the right to impose the fees against collateral (when there is equity) is critical. While lenders can assert such rights under bankruptcy law (See 11 USC § 506), having additional rights under the contract has always been thought to enhance such rights Under the *Penrod* holding this may no longer be the case.

Changing lender loan documents may help (assuming the lender clears the changes with any software vendor to avoid loss of warranties). Specially changing the fee provisions to reflect separate standards when bankruptcy disputes occur may help. There is a significant distinction between litigation re contractual rights and litigation to determine the valuation of the security given for the loan. This is clearly recognized under 11 USC Section 506, which only provides that a creditor have an allowed claim and that there be equity for the creditor to collect fees. Providing that bankruptcy valuation issues are not deemed to be disputes re the contractual rights, and/or providing that a borrower will not be allowed to assert the right to attorney's fees in a valuation context may help. Clearly, debtors will assert the *Penrod* holding to combat such efforts. Another approach is to remove the attorney's fees provisions altogether, which may impact rights outside of bankruptcy for solvent borrowers.

Two things are certain: First: The *Penrod* case gives debtors a powerful tool and more leverage in the bankruptcy courts. Second: Debtors' counsel will use this leverage to chill lender rights re collateral securing a loan.

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1 So called "910 loans" giving creditors special rights to repayment when a loan is a purchase-money loan incurred within 910 days of the filing (See 11 USC § 1325 (a)).

2 See *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.*, 549 U.S. 443, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007).

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