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A Recent Change to U.S. Bankruptcy Code Complicates Treatment of Penalties for Unpaid State and Local Taxes

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) amended a section of the U.S. Bankruptcy Code related to the treatment of post-petition penalties on oversecured claims, including property tax claims. The question now arises whether penalties are "fees, costs, or charges" recoverable under § 506(b) of the Bankruptcy Code. In this article, the authors analyze the revision of the Bankruptcy Code under BAPCPA and discuss the treatment of penalties in a relevant case, *In re Brentwood Outpatient*.

Introduction

When a debtor files for Chapter 11 bankruptcy, tax claims filed against the debtor must be analyzed to determine whether the taxes were incurred before filing (pre-petition), whether the amount of tax is in dispute, what priority the claim should be afforded, and whether penalties and interest should be allowed. Property tax claims are often large, and if the debtor is prevented from paying the property tax at issue until emergence (because the tax was incurred pre-petition),[1] the interest and penalties on such taxes can be substantial. Because local taxing authorities depend on property taxes to run their schools and essential government programs, they often aggressively defend their right to interest and penalties. While debtors have been able to successfully fend off claims for post-petition incurred penalties in the past,[2] following the Bankruptcy Abuse

[1] For an in-depth discussion of the treatment of pre-petition tax claims, see Carl M. Jenks, Candace A. Ridgway & Edward A. Purnell, 790 T.M., *Corporate Bankruptcy*, at V.D. (2004) (Jenks, *et al.*, 790 T.M. *Corporate Bankruptcy*).

[2] The focus of this article is the treatment of penalties incurred post-petition with respect to pre-petition property tax claims. If the underlying property taxes were incurred post-petition, the property tax (and any interest and penalties related to those taxes) are treated as an administrative claim. For a discussion of the treatment of administrative tax claims, see Jenks, *et al.*, 790 T.M., *Corporate Bankruptcy*, at V.D.

Prevention and Consumer Protection Act of 2005 (BAPCPA), which amended U.S. Bankruptcy Code § 506(b),[3] debtors (and their counsel) have been forced to reexamine whether bankruptcy law is still on their side.

Treatment of Penalties and Interest

Taxing authorities are generally allowed matured interest (interest that accrued prior to the petition date) at the state statutory rate on pre-petition tax claims.[4] Allowed matured interest is treated as secured, eighth-priority, or unsecured nonpriority depending on the priority of the underlying tax claim.[5] Claims for interest accruing on unpaid pre-petition taxes *after* the petition date are generally not allowed,[6] but there are exceptions. For example, post-petition interest may accrue when the taxing authority has a lien on the debtor's assets (or a right of setoff) that adequately secures both the pre-petition taxes and any accruing interest (oversecured tax claims).[7] Real property taxes are the most common type of oversecured tax claims.

With respect to penalties, taxing authorities are generally allowed penalties that were incurred *prior* to the filing of the bankruptcy petition on pre-petition tax claims.[8] Pre-petition penalties are divided into two categories: pecuniary (those that compensate a tax authority for its costs) and nonpecuniary (those that are in the nature of deterrents). Generally, pre-petition pecuniary penalties are allowed and given eighth-priority status, but nonpecuniary penalties are treated as unsecured nonpriority claims.[9] With respect to post-petition incurred penalties, prior to BAPCPA, debtors relied on *United States v.*

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[3] Pub. L. No. 109-8, § 1501, 119 Stat. 23, 216. Title 11 U.S.C. is referred to as the "Bankruptcy Code" or "B.C." in this article.

[4] *See* B.C. §§ 502(b)(2) (claims for "unmatured interest" not allowable), 511(a) (rate of interest shall be the rate determined under applicable nonbankruptcy law).

[5] *See* B.C. §§ 506(b), 507(a)(8)(G). An allowed pre-petition tax claim is secured when there is a lien on the property of the estate (or a right to a setoff). If an allowed pre-petition tax claim is not secured, the claim is either eighth-priority (if it falls within one of the B.C. §507(a)(8) categories) or unsecured nonpriority. In a Chapter 11 reorganization, allowed secured and eighth-priority claims are paid in full, whereas allowed unsecured nonpriority claims are often paid only cents on the dollar.

[6] *See* B.C. § 502(b)(2) (claims for "unmatured interest" not allowable); *New York v. Saper*, 336 U.S. 328 (1949) (payment of post-petition interest on pre-petition New York City taxes prohibited); *In re Fullmer*, 962 F.2d 1463 (10th Cir. 1992) (payment of post-petition interest on pre-petition federal taxes prohibited). *See also* 4 *Collier on Bankruptcy* ¶ 502.03[3][a] (15th ed. rev.); Gordon D. Henderson & Stuart J. Goldring, *Tax Planning for Troubled Corporations* §§ 301, 1006.1.2 (2007 ed.); Jenks, *et al.*, 790 T.M. *Corporate Bankruptcy*, at III.D.2 and IV.D.5.c.

[7] *See* B.C. § 506(b).

[8] *See, e.g., In re Brentwood Outpatient Ltd.*, 43 F.3d 256, 262 (6th Cir. 1994); *see also In re Gledhill*, 164 F.3d 1338, 1340 (10th Cir. 1999); *In re Murphy*, 279 B.R. 163, 165 (Bankr. M.D. Pa. 2002).

[9] *See* B.C. § 507(a)(8)(G) (which refers to penalties in "compensation for actual pecuniary loss"); *see also* Jenks, *et al.*, 790 T.M., *Corporate Bankruptcy*, at IV.D.5.d.

Ron Pair Enterprises,[10] and the court's interpretation of B.C. § 506(b) (pre-BAPCPA), to support the position that penalties incurred post-petition on oversecured pre-petition taxes are not allowed. Following the passage of BAPCPA, however, the change to B.C. § 506(b) has caused a split in professional opinion.

Ron Pair Enterprises And Amendment of B.C. § 506(b)

Generally, under the holding of Ron Pair, post-petition interest is allowed on oversecured claims under B.C. § 506(b). For the most part, bankruptcy professionals have assumed Ron Pair held that post-petition penalties are allowed under B.C. § 506(b) only if they are provided for under an agreement, which is unlikely for a tax claim.11 BAPCPA amended B.C. § 506(b) by adding "or State statute" to the last sentence; therefore, the section now reads:

> 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.[12]

Does the amendment to B.C. § 506(b) mean that a state may now collect post-petition penalties on oversecured tax claims? In other words, has BAPCPA effectively overturned the second "holding" of *Ron Pair*?

Bankruptcy treatise authors are seemingly split on these questions. Collier notes that after BAPCPA, a state may now collect fees, costs, or charges, but does not use the word "penalties."[13] Henderson & Goldring say "fees, costs or charges" in one section and "fees, costs or other charges (including penalties)" in another.[14] Norton says a state may now collect penalties under state statute, but in the next breath says penalties are not fees, costs, or charges.[15]

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[10] 489 U.S. 235, 241 (1989).

[11] *Id.*

[12] B.C. § 506(b) (emphasis added).

[13] 4 *Collier on Bankruptcy* ¶ 506.04 (15th rev. ed.) ("In general, section 506(b) provides for the allowance of fees (including attorney's fees), costs, and charges as part of an oversecured creditor's allowed secured claim, provided that fees, costs, and charges are (i) reasonable, and (ii) are provided for under the agreement, or state statute, under which the creditor's claim arose.") (citations omitted).

[14] Henderson & Goldring, *Tax Planning for Troubled Corporations* §§ 301 n.2, 1015 n.4 (2007 ed.).

[15] *Norton Bankruptcy Law and Practice* 2d § 43:3 (2006) ("Despite the prior case law, it appears that Congress in the 2005 Amendments . . . has allowed the enforcement of tax penalties for oversecured creditors if they are provided for by state statute by inserting the words `or State Statute' in the last sentence of section 506(b). Further, penalties are not allowable under § 506(b) even if the agreement so

Accordingly, the questions addressed in this article are:

- whether penalties are "fees, costs, or charges"; and
- if penalties are fees, costs, or charges, whether penalties are patently unreasonable and, thus, unrecoverable under B.C. § 506(b).

Are Penalties Fees, Costs, Or Charges?

Legislative History

The legislative history is silent as to the reason for the addition of the phrase "or State statute" to B.C. § 506(b), even though the amendment has been included in bankruptcy reform bills since 1998. The Conference Report for BAPCPA simply states, "section 506(b) [is amended] to provide that to the extent that an *allowed claim* is oversecured, the holder is entitled to interest and any *reasonable* fees, costs or charges provided for under state law."[16]

Case Law

No cases that we are aware of construe B.C. § 506(b) as amended with respect to penalties.[17] Prior to BAPCPA, courts could disallow (or allow only as general unsecured claims) post-petition penalties on state tax claims because they were not provided for under an agreement; thus, most courts did not need to analyze specifically whether penalties are "fees, costs or charges." Many courts, however, analyze penalties under B.C. § 506(b) and *Ron Pair*, thereby appearing to assume that penalties are fees, costs, or charges.[18] On the other hand, some parties and courts considered the language in

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provided because they are not included in the definition of `charges.' Rather, such charges were generally believed to be intended to include prepayment charges and late charges authorized under the agreement so long as they are reasonable under state law and Code § 506(b).") (citations omitted). For the proposition that penalties are not charges, Norton cites only *Brentwood Outpatient*, assumingly pointing to the lower court cases. *See* discussion below.

[16] *See, e.g.*, H. Rep. No. 107-617, 107th Cong., at 246 (2002) (emphasis added).

[17] The *In re Jones* court does note that "the term `penalties' does not appear in 11 U.S.C. § 506(b)," but the parties appear not to have noticed or argued this point, perhaps because whether penalties are fees, costs, or charges is not the central issue in the case. 2007 WL 1170620 (Bankr. S.D. Tex. 2007). At issue is whether the County could collect interest on interest, penalties, and attorneys' fees. The court notes that the word "charges" is used, but both parties used the term "penalties" in the case at bar. Although the court notes the issue, it seems ready, in dictum, to accept that B.C. § 506(b) covers penalties because the applicable Texas statute uses the term "penalties." *Id.* at *5 n.1. We would disagree that the use of the term "penalties" in a state statute is relevant to whether penalties are included in the term "charges" under B.C. § 506(b).

[18] *In re Pointer*, 952 F.2d 82, 89 (5th Cir. 1992) (penalties not part of secured claim because not

Ron Pair as to fees, costs, or charges as mere *dicta*.[19] Indeed, post-petition penalties *were not at issue in Ron Pair*; the facts implicated only post-petition interest. Finally, some courts simply state that penalties fall under B.C. § 506(b), offering no analysis: "All creditors can recover interest on an oversecured claim, but only creditors who have voluntary secured claims can recover *penalties*, fees, and costs."[20] Arguably, penalties may be reasonable if agreed to by consent of the parties. Statutory punitive claims are not voluntary and much less likely to be viewed as reasonable.

Examples of items courts have generally allowed under B.C. § 506(b) are late charges (which may resemble some penalties),[21] prepayment premiums,[22] foreclosure costs,[23]

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provided for under an agreement); *In re Parr Meadows Racing Assn.*, 880 F.2d 1540, 1549 (2d Cir. 1989) (same); *In re Building Techs. Corp.*, 167 B.R. 853, 859 (Bankr. S.D. Ohio 1994) (same); *Galveston Indep. Sch. Dist. v. Heartland Fed. Savings & Loan Assn.*, 159 B.R. 198, 203 (S.D. Tex. 1993) (same); *In re Summit Ventures Inc.*, 135 B.R. 483, 492 (Bankr. Vt. 1991) (same); *In re California Wholesale Elec. Co.*, 121 B.R. 360, 367 (Bankr. C.D. Cal. 1990) (same). These cases, however, are not decisive as to whether penalties are fees, costs, or charges because the courts did not specifically address the issue.

[19] *Pointer*, 952 F.2d at 89 ("[The Taxing Units] also contend that the language in *Ron Pair* regarding the recovery of fees and costs is mere dicta. . . . [W]hile the Supreme Court's language in *Ron Pair* may be dicta, it has been adopted by several courts of law."); *In re Manchester Lakes Associates*, 117 B.R. 221, 223 (Bankr. E.D. Va. 1990) ("*Ron Pair* did not definitively decide whether section 506(b) bars recovery of a pre-petition nonconsensual claim for tax penalties.").

[20] *Pointer*, 952 F.2d at 89 (emphasis added); *Galveston*, 159 B.R. at 203 ("Authorities are not entitled to *penalties*, fees, and costs accruing on an involuntary secured claim while the attached property is subject to the Code's automatic stay.") (emphasis added); *In re Aguilar*, 312 B.R. 394, 397 (D. Ariz. 2003) ("Courts have treated penalties as being within the category of `fees, costs, and charges' that are `allowed if they are reasonable and provided for in the agreement under which the claim arose.'") (citing *Pointer*).

[21] *Mack Financial Corp. v. Ireson*, 789 F.2d 1083 (4th Cir. 1986); *In re LHD Realty Corp.*, 726 F.2d 327 (7th Cir. 1984) (late charge recoverable if reasonable); *In re Hernandez*, 303 B.R. 342 (Bankr. S.D. Ohio 2003) (where, pursuant to promissory note, late charges were to be assessed in the amount of 5 percent of the late payment, oversecured creditor would be allowed such charges only on the monthly payment amount, and not on the entire balance due under the note, even where note had matured, as the court reasoned that late charges are allowable only if reasonable); *In re Vest Associates*, 217 B.R. 696 (Bankr. S.D.N.Y. 1998) (oversecured creditor entitled to recover late charges as provided in note even though debtor was making adequate protection payments during case which were approximately equal to note payments); *In re 1095 Commonwealth Ave. Corp.*, 204 B.R. 284 (Bankr. D. Mass. 1997), *aff'd. as modified*, 236 B.R. 530 (D. Mass. 1999) *as modified*, 236 B.R. 530 (D. Mass. 1999) (oversecured creditor could recover late fees or default interest, but not both).

[22] *In re Lappin Elec. Co. Inc.*, 245 B.R. 326 (Bankr. E.D. Wis. 2000) (early termination fee was reasonable charge otherwise allowable under Illinois law, and thus oversecured creditor entitled to charge and collect same); *In re Anchor Resolution Corp.*, 221 B.R. 330 (Bankr. D. Del. 1998) (oversecured creditor allowed to recover prepayment premium); *In re Duralite Truck Body & Container Corp.*, 153 B.R. 708 (Bankr. D. Md. 1993) (prepayment fee allowable under § 506(b) if charges bear reasonable relationship to lender's actual loss). *But see In re Schwegmann Giant Supermarkets P'ship.*, 264 B.R. 823 (Bankr. E.D. La. 2001) (oversecured creditor not allowed to claim prepayment premium as part of its claim where the amount and calculation of same were unreasonable); *Foothill Capital Corp. v. Official*

court costs,[24] and liquidated damages.[25]

Brentwood: Introduction

We are aware of only one case, *In re Brentwood Outpatient*,[26] that examines in detail whether penalties are fees, costs, or charges. Although the court finds that penalties are not fees, costs, or charges, which is helpful, the result in the case is unusual in that the court allows the post-petition penalties as part of the *secured* claim. Previous to BAPCPA, many bankruptcy professionals and courts understood B.C. § 506(b) to either disallow altogether claims that did not arise under an agreement or to at least relegate them to unsecured status.[27] If we follow the *Brentwood* holding that penalties are not fees, costs, or charges, must we also follow its holding that penalties are allowed as a secured claim? If both holdings are correct, a debtor under current law would seem to have nothing to gain by arguing that penalties are not fees, costs, or charges.

The *Brentwood* bankruptcy case, however, appears wrongly decided, as discussed below in this article. Allowance of the penalty claim as secured leads to unacceptable incongruities and contradicts policies that underlie the Bankruptcy Code. On review, the U.S. Court of Appeals for the Sixth Circuit eventually reversed the lower court, holding that penalties were not allowed under *Ron Pair* because they did not arise under an agreement.[28] It is possible that a court may be persuaded by the *Brentwood* bankruptcy court's holding that:

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Unsecured Creditors ' Comm. of Midcom Communications Inc., 246 B.R. 296 (E.D. Mich. 2000) (oversecured lender not allowed to charge early termination penalty, as contract had not actually terminated).

[23] *See, e.g.*, *In re Ladycliff College*, 56 B.R. 765 (S.D.N.Y. 1985).

[24] *See, e.g.*, *In re Calzaretta*, 35 B.R. 92 (Bankr. N.D. Ill. 1983).

[25] *In re Direct Transit Inc.*, 226 B.R. 198 (B.A.P. 8th Cir. 1998) (oversecured lender allowed to recover liquidated damages under § 506(b) where such damages are recoverable under state law); *In re Vanderveer Estates Holdings Inc.*, 283 B.R. 122 (Bankr. E.D.N.Y. 2002) (allowing oversecured creditor to increase its total secured claim, under § 506(b), based upon yield maintenance provision in contract).

[26] 134 B.R. 267 (Bankr. M.D. Tenn. 1991).

[27] There is some disagreement whether B.C. § 506(b) acted to disallow fees, costs, or charges that did not arise under an agreement in their entirety or merely relegated them to unsecured status. The cause of the confusion was *Ron Pair* itself: "in the absence of an agreement, post-petition interest is the only added recovery available." 489 U.S. at 241. *See In re Tricca*, 196 B.R. 214, 219 (1996) ("Section 506(b) is not a provision which concerns itself with claim allowance. Section 506(b) addresses only the question of what is part of an `allowed secured claim.' Those courts which have examined § 506(b) in conjunction with § 502 have concluded that § 506(b) does not create additional exceptions to the allowance of claims; rather it only provides for the classification of allowed claims as secured or unsecured.") (citing cases).

[28] *In re Brentwood Outpatient Ltd.*, 43 F.3d 256, 263 (6th Cir. 1994). The Sixth Circuit described the lower court opinions as "thoughtful" and "well-reasoned."

- B.C. § 506(b) does not apply to allow penalties, and

- the very inapplicability of B.C. § 506(b) acts to allow the penalty claim as secured.

Thus, this article examines the holdings of the *Brentwood* cases to determine the basis for these decisions and what impact they may have on the issue of whether penalties are costs, fees, or charges post-BAPCPA.

***Brentwood*: Facts**

In *Brentwood,* the debtor filed for bankruptcy in August 1989. The county asserted a claim for 1989 real property taxes plus interest, penalties, fees, and costs. In the county, the lien date for the taxes was Jan. 1, 1989; thus, the taxes were incurred pre-petition. The taxes were due in October 1989; thus, the interest and penalties were post-petition. The plan for reorganization provided for payment in full of the allowed secured claim of the county. The Bondholder Committee conceded the county's right to post-petition interest, but contested the county's claim for penalties, fees, and costs.

***Brentwood*: Bankruptcy Court (1991)**

The bankruptcy court in *Brentwood* allowed the post-petition penalties at issue as secured claims, reasoning that penalties were not expressly mentioned in B.C. § 506(b).[29] First, the bankruptcy court disallowed under *Ron Pair* the county's claim for post-petition fees and costs because they arose by operation of law. With respect to the penalties, however, the court allowed them as a secured claim because "[i]f § 506(b) is inapplicable, no `applicable law' disallows claims for tax penalties in a Chapter 11 case."[30] The bankruptcy court cites no authority for this statement, which seems to contradict equitable principles of bankruptcy. The court disagreed with the *Parr Meadows* court that *Ron Pair* governed the penalty question, instead finding that *Ron Pair* had not definitely decided the issue.[31]

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[29] *In re Brentwood Outpatient*, 134 B.R. 267, 270–73 (Bankr. M.D. Tenn. 1991).

[30] *Id.* at 273.

[31] *Id.* at 270 (citing *In re Manchester Lakes Assn.*, 117 B.R. 221 (Bankr. E.D. Va. 1990)); *Matter of Specialty Cartage Inc.*, 115 B.R. 164 (N.D. Ind. 1989); *In re Stack Steel & Supply Co.*, 28 B.R. 151 (Bankr. W.D. Wash. 1983); *In re Mitchell*, 39 B.R. 696 (Bankr. D. Or. 1984); *In re Russo*, 63 B.R. 335 (Bankr. D. Mass. 1986); *In re Seneca Balance Inc.*, 114 B.R. 378 (Bankr. W.D.N.Y. 1990). Note that all but one of these cases predate *Ron Pair*. *Manchester Lakes* argues that *Ron Pair* is dicta as to penalties. The remainder of the cases allow penalties based on the legislative history of § 506(b).

In holding that penalties should be allowed as secured, the *Brentwood* bankruptcy court reasoned that the legislative history of the Bankruptcy Reform Act of 1978 demonstrated that Congress contemplated that liens securing penalties would be valid in Chapter 11 cases following enactment of the Code (but voidable in Chapter 7 cases). The court focuses on § 57(j) of the Bankruptcy Act (former 11 U.S.C. § 93(j)), which Congress did not reenact. Section 57(j) read as follows:

> Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

Accordingly, § 57(j) disallowed any governmental claim that was clearly for a penalty—amounts for pecuniary loss were allowed. The rationale for disallowance was that creditors should not bear the burden of a penalty incurred by the debtor before the bankruptcy and due to his own delinquency.[32]

Congress, the *Brentwood* bankruptcy court implies, could not simply reenact § 57(j) because doing so would continue the prohibition on all tax penalty claims, which Congress did not want to do. According to the court, under the new Bankruptcy Code, Congress wished to allow claims for tax penalties secured by liens in Chapter 11 cases. Accordingly, the court concludes that claims for tax penalties secured by liens are allowed in Chapter 11 cases, but not in Chapter 7 cases. The court reasons to this position from a passage in the legislative history of the Bankruptcy Reform Act of 1978 pertaining to B.C. § 724(a).

Section 724 involves the treatment of certain liens in bankruptcy. Section 724(a) provides that a trustee may avoid a lien for any allowed claim for any penalty to the extent that such penalty is not for pecuniary loss suffered by the holder of such claim. The Senate Report for this section recites that B.C. § 724(a) continues § 57(j)'s policy of protecting unsecured creditors from the debtor's wrongdoing, explaining:

> The lien is made voidable rather than void in chapter 7, in order to permit the lien to be revived if the case is converted to chapter 11, under which penalty liens are not voidable. To make the lien void would be to permit the filing of a chapter 7, the voiding of the lien, and the conversion to a chapter 11, simply to avoid a penalty lien, which should be valid in a reorganization case.[33]

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[32] *Bankruptcy: Disallowance of Claims for "Penalties" Under 11 US Code § 93(j),* 1 A.L.R. Fed 657.

[33] S. Rep. No. 989, 95th Cong., 2d Sess. 96, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5882.

The court latches onto the provision that a penalty lien may be revived and is not voidable in a Chapter 11 case, extrapolates from there that Congress intended penalties to be allowed in a Chapter 11 case, and allows the penalty claim at issue.

To support its holding, the *Brentwood* bankruptcy court had to distinguish *Parr Meadows*, which disallowed penalties under *Ron Pair*. The court did so by noting that *Parr Meadows* had been converted to a Chapter 7 case. Similarly, the *Brentwood* bankruptcy court distinguished *In re Pointer*, a Chapter 11 case, because *Pointer* had followed *Parr Meadows* without noting that *Parr Meadows* was a Chapter 7 case.

As additional support for its holding that B.C. § 506(b) does not address penalties, the court reasoned that penalties are not fees, costs, or charges. The legislative history of B.C. § 506(b) did not reveal that "fees, costs [or] charges were intended to include `penalties.'"[34] The *Brentwood* bankruptcy court noted that the drafters of the Bankruptcy Code elsewhere had used the words "penalties," "fees," "costs," and "charges" as if their meanings were distinct.[35] The court noted that the dictionary definitions of these words at that time were dissimilar.[36] Similarly, today a "penalty" is defined as a punishment imposed on a wrongdoer, especially in the form of imprisonment or fine, or an excessive liquidated damages clause,[37] and a "charge" is an "encumbrance, lien, or claim."[38] A "cost" is an amount paid or charged for something.[39] A "fee" is a charge for labor or services.[40]

The *Brentwood* bankruptcy court had to acknowledge that its holding led to an odd result for holders of oversecured, nonconsensual tax claims: the Bankruptcy Code supposedly allowed penalties, which are noncompensatory in nature, but disallowed

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[34] *Brentwood Outpatient*, 134 B.R. at 272.

[35] *See, e.g.*, 11 U.S.C. § 107(a) (access to court records without "charge"); 11 U.S.C. § 322(c) (trustee not liable personally for "penalty or forfeiture"); 11 U.S.C. § 328(a) ("contingent fee"); 28 U.S.C.S. § 1930 (Law. Co-op. 1989) (bankruptcy "fees"); 28 U.S.C.S. § 1930 note on Bankruptcy Court Fee Schedule 819 (Law. Co-op. Supp. 1991) ("The clerk shall assess a charge of up to three percent … ."); 11 U.S.C. § 507(a)(7)(G) ("the actual, necessary costs"); 11 U.S.C. § 503(b)(1)(C) ("any fine, penalty"); 11 U.S.C. § 503(b)(6) ("the fees and mileage"); 11 U.S.C. § 505(a) ("the amount . . . of any . . . penalty"); 11 U.S.C. § 507(a)(1) ("any fees and charges"); 11 U.S.C. § 726(a)(4) ("fine, penalty, or forfeiture"). *See also* Fed. R. Bankr. P. 7054(b) ("The court may allow costs . . .").

[36] Citing the 1968 edition of *Black's Law Dictionary*, the court wrote, "`Penalties' conventionally include some concept of punishment. `Charges' involve ordinary duties, burdens or obligations. A `fee' usually includes compensation for goods or services. `Costs' typically include reimbursement of expenses to an officer or agency." *Brentwood Outpatient*, 134 B.R. at 272.

[37] *Black's Law Dictionary* at 1153 (7th ed. 1999).

[38] *Id.* at 227.

[39] *Id.* at 349.

[40] *Id.* at 629.

fees, costs, and charges, which are compensatory in nature. The court explained this "wrinkle" in Chapter 11 cases by saying that:

> Under the former Bankruptcy Act, *contractual* rights to attorneys' fees, if valid under state law, were enforceable as part of an oversecured claim in bankruptcy. This rule was not changed with the enactment of the Code. In contrast, as demonstrated above, penalties were not allowed to even an oversecured claim holder by operation of former § 57j. The Congressional decision to eliminate § 57j and to allow penalty claims in Chapter 11 cases left a slight incongruity in the law with respect to `compensatory' fees, costs and charges claimed by nonconsensual lien holders in Chapter 11 cases.[41]

Analysis of *Brentwood* Bankruptcy Court Opinion

The *Brentwood* opinion is helpful in that it notices and answers in the negative a question presented for this article—whether penalties are fees, costs, or charges. A danger with the opinion is that a court may be persuaded that a secured claim for penalties should be allowed under B.C. § 506(b) instead of disallowed. Allowance of a secured claim for tax penalties would contradict the general understanding held by courts and bankruptcy professionals that B.C. § 506(b) acts either to disallow or accord unsecured status to post-petition additions to claims.

However, to accept that penalties are not fees, costs, or charges *also* will go against the widely held belief of bankruptcy professionals. Until BAPCPA, even though *Ron Pair* may not explicitly or implicitly hold so, debtors' counsel often interpreted *Ron Pair* to apply to penalties, and acted on that understanding in negotiating settlements with local taxing authorities. Indeed, even Henderson and Goldring appear to assume, or at least be confused by whether, B.C. § 506(b) (and with that section, *Ron Pair*) applies to penalties.[42] Accordingly, if acceptance that penalties are not fees, costs, or charges will be a significant about-face, there is some risk a court could rethink whether B.C. § 506(b) acts to disallow or relegate to unsecured status post-petition items.

Despite these risks, it seems unlikely that allowance of a secured penalty claim under B.C. § 506(b) is the correct result. First, the *Brentwood* bankruptcy court's legislative history argument does not sustain statutory interpretational rigor. Interpreting Congress' failure to reenact § 57(j) as the congressional blessing of a new policy allowing secured claims for tax penalties in Chapter 11 cases seems to strain rules of statutory interpretation.[43] Although penalty liens may not be voidable in Chapter 11 cases, this

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[41] *Brentwood Outpatient*, 134 B.R. at 273 (emphasis in original).

[42] Henderson & Goldring say post-BAPCPA, a state may now collect "fees, costs or charges" in one section and "fees, costs or other charges (including penalties)" in another. Henderson & Goldring, *Tax Planning for Troubled Corporations,* §§301 n.2, 1015 n.4 (2007 ed.).

[43] In *Ron Pair*, the court disagreed that Congress' failure to repudiate a distinction between consensual

does not mean that penalties must therefore be allowed. Congress could have expressly provided for penalty claims in B.C. § 506(b), a much simpler route, but it did not.

Further, the *Brentwood* bankruptcy court's neat understanding of the legislative history runs afoul of the pre-Bankruptcy Code confusion that existed (and continues to exist) on the issue of pre- and post-petition penalties. Courts' uncertainty about how to handle the "grey-area" fact pattern (taxes are incurred before the petition→bankruptcy petition is filed→taxes are due→taxes are not paid→penalties are added to tax) dates back to at least 1941.[44] It appears either § 57(j) did not fully address the grey area,[45] courts did not yet understand the above fact pattern to be a grey area,[46] or the 1898 Bankruptcy Act did not lend itself to resolution of the grey area.[47] To conclude from a single passage of legislative history that Congress had suddenly clarified that claims for tax penalties are allowed in Chapter 11 cases would seem to be reaching.

Finally, as the court points out, there is a wrinkle that results from its allowance of the penalty claims: that the Bankruptcy Code supposedly allowed penalties but disallowed fees, costs, and charges. The court's attempt to dismiss this as an oversight of Congress is an unsatisfactory explanation. In theory, the Bankruptcy Code should not have incongruities, especially one that cuts against a long-standing policy of bankruptcy law to favor pecuniary losses over nonpecuniary losses.[48] Additionally, secured claim

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(continued…)

and nonconsensual liens required the court to enforce such a distinction. A similar argument should apply here: Congress' failure to reenact §57(j) should not require courts to assume that Congress intended that penalties be allowed in Chapter 11 cases. 489 U.S. 235, 243 (1989).

[44] This precise pattern was before the court in *In re Chicago & N.W. Ry. Co.*, 39 F. Supp. 147 (N.D. Ill. 1941). The court held that the bankruptcy estate was liable for the penalties because according to the court, the penalties did not accrue until after the appointment of the trustee. The court concluded the opinion saying, "The matter is not free from doubt and the court will be glad to have the matter presented to a reviewing court." The U.S. Court of Appeals for the Seventh Circuit affirmed. 119 F.2d 971 (7th Cir. 1941).

[45] Courts construed § 57(j) to apply to the pre-bankruptcy period only. *See Boteler v. Ingels*, 308 U.S. 57 (1939).

[46] Courts were uncertain what it meant to "incur" taxes and penalties. *See, for example, Chicago & N.W. Ry. Co.*, 39 F. Supp. 147, which recognized that the taxes at issue were levied before the bankruptcy but that penalties "accrued" post-bankruptcy.

[47] The act provided for pre-arrangement, arrangement, and bankruptcy periods. The arrangement period allowed for reorganization, and if that failed, a bankruptcy petition was filed. The three different periods muddy the analysis regarding interest and penalties. *See, for example, Nicholas v. United States*, 384 U.S. 678 (1966), which denied interest on taxes during the arrangement period but allowed penalties in the bankruptcy period.

[48] *See, for example,* B.C. § 507(a)(8)(G), according eighth priority status for penalties related to a claim and in compensation for pecuniary loss, and old § 57(j), which disallowed penalties except those for pecuniary loss.

status for post-petition penalty claims comes at the expense of other creditors, which is anathema to bankruptcy policy: creditors should not be disadvantaged vis-a`-vis one another due to the administration of the bankruptcy laws.[49] The automatic stay prevents the debtor from paying the taxes that were incurred pre-petition and the penalties that accrue on those taxes post-petition; unsecured creditors should not see their recoveries reduced because penalty claims, which the debtor is prevented from paying, accord secured status. Therefore, although it is possible that a court could reverse the generally accepted understanding that B.C. § 506(b) is a disallowance provision, it appears unlikely.

The *Brentwood* bankruptcy court case is helpful, though, in that it holds that penalties are not fees, costs, or charges. At the very least, that the court noticed the issue lends credence to the question. However, the bankruptcy court sitting in the Southern District of Ohio rejected the argument made in *Brentwood*, finding it to be too narrow a reading of the terms "fees," "costs," or "charges," stating, "'[c]harges' is a broad enough term to include penalties, particularly when the Supreme Court in *Ron Pair* expressly excluded from recovery anything other than post-petition interest."[50]

***Brentwood*: District Court (1993) And Sixth Circuit (1994)**

In much less lengthy treatment, the district court affirmed the *Brentwood* bankruptcy court's holding, adding no new analysis.[51] The Sixth Circuit reversed the lower court holding as to penalties because it interpreted *Ron Pair* to hold that no post-petition additions to claims are allowable in Chapter 11 cases except as provided by B.C. § 506(b).[52] The court thought it unwise from points of federalism and public policy that the Bankruptcy Code should favor private creditors over state taxing authorities.[53] Between B.C. § 506(b) and *Ron Pair*, however, the court felt its hands were tied. In a footnote, the court stated: "We need not decide today whether a consensual oversecured creditor would have priority for post-petition penalties provided for in a security agreement—i.e., whether `penalties' are in the category of `fees, costs, or charges' created by B.C. § 506(b). . . . It may be that Congress did not allow for penalties in B.C. § 506(b) precisely because they are punitive rather than compensatory."[54]

(continued…)

[49] *Nicholas*, 384 U.S. at 683.

[50] *In re Building Techs. Corp.*, 167 B.R. 853, 859 (Bankr. S.D. Ohio 1994).

[51] *In re Brentwood Outpatient Ltd.*, 152 B.R. 727 (M.D. Tenn. 1993).

[52] *In re Brentwood Outpatient Ltd.*, 43 F.3d 256, 263 (6th Cir. 1994).

[53] *Id.* at 262.

[54] *Id.* at 263 n.5.

Are Penalties Patently Unreasonable?

There is at least an argument that penalties that are punitive in nature, as opposed to pecuniary, are patently unreasonable because to punish a debtor for the automatic stay, which it cannot avoid, is unfair. Some past cases do assess the reasonableness of charges by inquiring as to the purpose of the charge, holding that charges that compensate for pecuniary or actual loss are "reasonable."[55] Such holdings, though, naturally raise the question of whether the allowed charges were really penalties in name only, causing the analysis to be irrelevant on our assumptions. Some cases provide guidance as to the reasonableness inquiry from their denial of certain prepayment penalty and late charges. A prepayment charge expressed as a fixed percentage of principal prepaid, regardless of the time of payment, has been rejected as unreasonable.[56]

Similarly, a clause that required a prepayment charge even though market rates had risen since the date of the loan also was deemed unreasonable.[57] Default rates of interest inordinately high in relation to the non-default rates similarly have been disallowed.[58] In one Southern District of New York case, the Bankruptcy Court found a 5 percent spread to be reasonable.[59] However, the judge implied that courts might enforce the high default rates if it could somehow be shown that they are compensation for injuries that the lenders have incurred.[60] Unfortunately, it is difficult to discern whether courts disallow the high rates because they are *de facto* penalties or because they are unreasonable. Arguably, any pecuniary or unreasonable charge should be excluded from treatment as a secured claim under B.C. § 506.

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[55] *In re Bridge Info. Sys. Inc.*, 288 B.R. 556, 564 (Bankr. E.D. Mo. 2002) (equating reasonable charges with actual damages and limit the allowable prepayment premium to the lender's actual, provable damages arising from prepayment); *In re Schaumburg Hotel Owners Ltd. P'ship.*, 97 B.R. 943, 953 (Bankr. N.D. Ill. 1989) (evaluating the reasonableness of the prepayment charge at the time the loan was made).

[56] *See In re Schwegmann Giant Supermarkets P'ship.*, 287 B.R. 649, 655-56 (E.D. La. 2002).

[57] *A.J. Lane & Co.*, 113 B.R. 821, 829 (Bankr. D.C. Mass. 1990).

[58] *Compare In re Hollstrom*, 133 B.R. 535, 539-40 (Bankr. D. Colo. 1991) (nondefault rate of 12 percent versus default rate of 36 percent); *In re DWS Investments*, 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990) (14 percent and 15 percent versus 25 percent); *In re White*, 88 B.R. 498, 511 (Bankr. D. Mass. 1988) (16.5 percent versus 48 percent), *with In re Terry*, L.P., 27 F.3d 241, 244 (7th Cir. 1994) (17.25 percent default rate versus 14.25 percent nondefault rate); *In re White*, 88 B.R. 494 (Bankr. D. Mass. 1988) (default rate of 19.25 percent versus 14.25 percent nondefault); *In re Skyler Ridge*, 80 B.R. 500 (Bankr. C.D. Cal. 1987) (default rate of 14.75 percent versus 10.75 percent nondefault).

[59] *In re Vest Associates*, 217 B.R. 696, 702 (Bankr. S.D.N.Y. 1998).

[60] *Id. Accord In re Hernandez*, 303 B.R. 342, 342 (Bankr. S.D. Ohio 2003) (suggesting that late charge of 5 percent on entire principal versus just the monthly payment (a $100,000 difference) might have been assessed had the contract explicitly provided).

Conclusion

Following the BAPCPA amendments, states may argue that they are allowed penalties incurred post-petition on oversecured pre-petition taxes on the assumption that penalties are "fees, costs, or charges." Although bankruptcy treatise authorities are split on whether penalties are "fees, costs, or charges," there is sufficient authority, both plain meaning and case law, that penalties are not fees, costs, or charges to support a debtor's objection to a claim for post-petition penalties arising under state statute. Notwithstanding the *Brentwood* decisions, a debtor that succeeds in arguing that penalties are not fees, costs, or charges should succeed in having the penalties disallowed (or at least reclassified as an unsecured nonpriority claim). While we believe the better answer is that penalties are not fees, costs, or charges, even if they were considered fees, costs, or charges, penalties arguably are unreasonable because they are punitive in nature. ■

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