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Post-Travelers, Bankruptcy Courts Split Over Allowance of Postpetition Attorneys' Fees as Part of Unsecured Creditor's Prepetition Contractual Claim

ANDREA C. SAAVEDRA

In the first decisions by the lower courts addressing the question left unanswered by the United States Supreme Court in *Travelers Casualty & Surety Ins. Co. of America v. Pacific Gas & Electric Co.*¹— whether a creditor may recover postpetition attorneys' fees and costs as part of its prepetition unsecured claim — the United States Bankruptcy Courts for the Northern District of California and the Middle District of Florida reached opposite conclusions.

In *In re QMECT, Inc.*,² the United States Bankruptcy Court for the Northern District of California held that, in the absence of applicable law to the contrary, a creditor was entitled to include its reasonable contract-based postpetition attorneys' fees as part of its prepetition unsecured claim. Less than two months later, in *In re Electric Machinery Enterprises, Inc.*,³ the United States Bankruptcy Court for the Middle District of Florida held that unsecured creditors were *not* entitled to recover such postpetition fees as part of a prepetition claim. The apparent conflict resulting from the courts' opinions results from their opposite conclusions about the meaning of applicable Bankruptcy Code provisions as well as their emphasis on two distinct policy rationales.

Andrea C. Saavedra is an associate in the New York City office of Weil, Gotshal & Manges LLP. She can be reached at andrea.saavedra@weil.com.

THE TRAVELERS DECISION

In *Travelers*, the Supreme Court resolved a conflict among the courts of appeals over whether a claim for contractually permitted postpetition attorney's fees may be disallowed solely because such fees were incurred while litigating issues of bankruptcy law. On the basis of the Ninth Circuit's earlier decision in *Fobian v. Western Farm Credit Bank*,⁴ the lower courts in *Travelers* disallowed a claim for such fees. The Supreme Court, however, refused to adopt the Ninth Circuit's judicially crafted "Fobian Rule," finding no statutory or common law justification for the rule's disparate treatment of legal disputes arising under bankruptcy laws.

The Supreme Court limited its holding to the issue of whether the fees could be denied solely on the basis that they arose in connection with litigating bankruptcy matters. Although the debtor had argued before the Court that the attorneys' fees should be disallowed because, when read together, Bankruptcy Code Sections 502(b) and 506(b) make it clear that an unsecured creditor may not recover postpetition attorneys' fees, the Court expressly declined to address the issue because it had not been raised below. Thus, the more general question of whether an undersecured or unsecured creditor is barred from asserting a claim for postpetition attorneys' fees on other grounds, including the reasons the debtor asserted in *Travelers*, remained unanswered.

SECTIONS 502(B) AND 506(B) OF THE BANKRUPTCY CODE

Section 502 of the Bankruptcy Code governs the allowance of claims and interests in a bankruptcy case. Section 502(b) provides the grounds for disallowance. These include, for example, that the claim or interest is not allowable under applicable law (Section 502(b)(1)) or that the claim is for unmatured interest (Section 502(b)(2)). Significantly, a claim for postpetition attorneys' fees is not identified in the statute as being subject to disallowance.

One provision of the Bankruptcy Code that does deal explicitly with attorneys' fees, however, is Section 506(b). Section 506 generally determines the value of a secured claim asserted against a debtor's estate. Section 506(b) expressly authorizes a creditor whose claim is

oversecured to recover, up to the value of its collateral, the reasonable prepetition and postpetition fees and costs provided for in the agreement or state statute under which the claim arose. Section 506(b) is silent as to whether a partially secured or an unsecured creditor may seek to recover any of its fees or costs. Thus, many courts held pre-*Travelers* that Section 506(b) implicitly precluded an undersecured or unsecured creditor from recovering on a claim for postpetition fees and costs.

IN RE QMECT, INC.

In *In re QMECT, Inc.*, an undersecured creditor sought an award of postpetition attorneys' fees and costs pursuant to various contracts that it had with the debtors. The creditor argued that in the absence of an explicit provision in Section 502(b) providing for the disallowance of its claim, disallowance was inappropriate where applicable Ninth Circuit law recognized the validity of its claim to the extent that it was provided for by contract or nonbankruptcy statute. In opposition, the debtor argued that because the Bankruptcy Code did not explicitly provide unsecured creditors with the right to recover postpetition attorneys' fees, the creditor's claims were implicitly barred by Section 506(b).

The court rejected the debtor's proposed reading of 506(b) on two grounds. First, the court reasoned that because Section 506 provides for the determination of a creditor's secured status, it was not a "logical place" to provide for the disallowance of an element of an unsecured claim. Had Congress wanted to disallow unsecured claims for postpetition attorneys' fees, the court reasoned that such explicit disallowance would have been more appropriately provided for in Section 502(b). Second, because Section 506(b) does not distinguish between prepetition and postpetition attorneys' fees, the court determined that the debtor's overbroad proposed reading of 506(b) also would result in the disallowance of an unsecured creditor's claim for its reasonable prepetition attorneys' fees.

Although the court recognized that allowing for the inclusion of postpetition attorneys' fees in an unsecured creditor's prepetition claim may augment the claim relative to the claims of other unsecured creditors, the

unequal treatment was tolerable where such a rule promoted the policy of preserving nonbankruptcy legal rights except to the extent absolutely necessary to facilitate the purpose of a bankruptcy case. Accordingly, the court held that in the absence of a clear provision in the Bankruptcy Code modifying a creditor's nonbankruptcy legal rights, those rights should be "deemed to be left intact." In so holding, the court echoed the principle articulated by the Supreme Court in *Travelers*, even though *Travelers* itself never reached the issue presented in *QMECT*.

IN RE ELECTRIC MACHINERY ENTERPRISES, INC.

In contrast to *QMECT*, the court in *In re Electric Machinery Enterprises, Inc.* found that the pre-*Travelers* majority rule, which generally disallowed unsecured creditors' claims for postpetition attorneys' fees, remained good law post-*Travelers*. In *Electric Machinery*, the creditor was a surety that had issued a subcontractor performance bond on behalf of a contractor. As an accommodation to the contractor, the debtor executed an indemnity agreement in favor of the creditor, agreeing to indemnify the creditor from any losses incurred with respect to the bond. Due to subsequent defaults by the contractor, a subcontractor obligee sued and obtained a judgment against the contractor and the creditor. The creditor's unsecured claim against the debtor sought the amount of the judgment, together with attorneys' fees incurred pre- and postpetition. In disallowing the creditor's claim, the court relied upon four different rationales, all of which had been articulated previously by the courts in the pre-*Travelers* majority.

First, applying certain principles of statutory interpretation, the court held that the plain language of Section 506(b) expressly bars an unsecured creditor from receiving postpetition attorneys' fees and costs. Second, the court found that the Supreme Court's decision in *United Savings Ass'n v. Timbers* required a similar conclusion. In *Timbers*, the Supreme Court held that because Section 506(b) only permitted postpetition interest to be paid out of an equity cushion (*i.e.*, the extent to which the value of a secured creditor's collateral exceeds the amount of its claim), neither an undersecured nor unsecured creditor can recover the

postpetition interest on their claims. By analogy, because Section 506(b) explicitly allows for secured creditors to recover attorneys' fees but does not provide similar allowances for unsecured creditors, the *Timbers* rationale applies with equal force to the disallowance of postpetition attorneys' fees and costs for both unsecured and undersecured creditors. Third, the court reasoned that allowing unsecured claims for postpetition attorneys' fees would be in derogation of Section 502(b), which requires the amount of a claim to be determined "as of the date of the filing of the petition" (*i.e.*, before postpetition fees could be incurred). Fourth, the court held that it would be inequitable to allow certain unsecured claimants (such as holders of contract claims that contain attorneys' fees provisions) to recover their attorneys' fees while other unsecured creditors (such as tort and trade creditors) would be barred from a similar recovery. Unlike the *QMECT* court, the *Electric Machinery* court determined that such unequal treatment would disrupt the "prime policy of bankruptcy law" to provide equality among similarly situated creditors.

In addition to these four rationales, the court expressed its concern about the administrative feasibility of allowing unsecured creditors to amend their claims repeatedly to include "ever-accruing" postpetition attorneys' fees. The court found that the practical impact of a contrary ruling (*i.e.*, the ruling issued in *QMECT*) would be intolerable.

CONCLUSION

The bankruptcy courts' decisions in *In re QMECT, Inc.* and *In re Electric Machinery Enterprises, Inc.* reflect that the issue unresolved by *Travelers* will continue to be the subject of conflicting interpretations by the bankruptcy (and appellate) courts and likely will come full circle, back to the Supreme Court. Meanwhile, creditors with claims for attorneys' fees will have to contend with the disparate treatment of their claims, depending on the jurisdiction in which the debtor commences its bankruptcy case. Such different results have no place in a federal bankruptcy system and ultimately need resolution by the Supreme Court or Congress.

NOTES

¹ *Travelers Cas. & Surety Ins. Co. of Am. v. Pac. Gas & Elec. Co.*, ___ U.S. ___, 127 S. Ct. 1199 (2007).

² *Qmect, Inc. v. Burlingame Capital Partners II, L.P. (In re QMECT, Inc.)*, 368 B.R. 882 (Bankr. N.D. Cal. 2007).

³ *In re Elec. Mach. Enters., Inc.*, No. 03-11047-MGW, 2007 WL 2031445 (Bankr. M.D. Fla. July 6, 2007).

⁴ *Fobian v. W. Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991).

⁵ *United Sav. Ass'n v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365 (1988).