

Claims for Post-Petition Legal Fees By Unsecured Creditors

By: James R. Schroll¹



Introduction

Bankruptcy practitioners are generally familiar with the rules which govern legal fee claims by over-secured creditors in bankruptcy proceedings. 11 U.S.C. § 506(b) plainly states that the holder of an allowed secured claim secured by property having a value greater than the amount of the claim is allowed “interest on such claim, and reasonable fees, costs, or charges provided for under the agreement or State statute under which the claim arose.” In other words, if a creditor is fortunate enough to have collateral with an equity cushion, it may include both post-petition interest and legal fees as part of its secured claim. Secured creditors lacking an equity cushion are precluded from adding post-petition interest or legal fees to their secured claims. The Supreme Court made this clear in its landmark ruling in *United Savings Ass’n v. Timbers of Inwood Forest*

Assocs. Ltd., 484 U.S. 365 (1988).

Bankruptcy practitioners also know that unsecured creditors may not include post-petition interest in their claims because 11 U.S.C. § 502(b) (2) lists claims for “unmatured interest” among the claims expressly disallowed. However, neither Section 506 nor Section 502 say whether or not legal fees incurred by an undersecured or unsecured creditor in the course of a bankruptcy proceeding are includable as part of an unsecured claim.² Did Congress’s silence on the issue mean that an unsecured creditor is free to include legal fees in its claim? Or, does it mean just the opposite?³

The courts have been all over the map on this question. In 2007, the Supreme Court, in *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007), expressly acknowledged the split in decisions

on this issue but refused to resolve the issue because, in the Court’s opinion, it had not been properly raised below. Consequently, lower courts have continued to issue opinions on both sides of the issue.

Travelers has had a particularly interesting impact in Virginia. Judge Anderson, the author of a leading opinion disallowing legal fee claims by unsecured creditors (*In re Saunders*, 130 B.R. 208 (Bankr. W.D.Va 1991)), pointed to *Travelers* in support of his recent opinion in which he switched camps and ruled that an unsecured creditor was in fact entitled to include its post-petition legal fees as part of its allowed claim. *In re Gfroefler*, No. 04-02531-LYN (Bankr. W.D. Va. Sept. 22, 2008). Another Virginia bankruptcy judge and one in Maryland previously followed Judge Anderson’s opinion in *In re Saunders* in disallowing legal fees claims by unsecured creditors.⁴ It

remains to be seen whether other bankruptcy judges in Virginia or elsewhere will decide to follow Judge Anderson's lead and rule that legal fees incurred by an unsecured creditor in a bankruptcy proceeding are allowable.

In *In re Saunders*, Judge Anderson had explained his reasoning for disallowing legal fees to an unsecured creditor as follows:

11 U.S.C. § 506(a) provides that an unsecured creditor has an unsecured claim for the deficiency. Section 506(b), which expressly allows contractually authorized attorneys' fees for secured claims, immediately follows Section 506(a). If attorneys' fees were allowable on the unsecured portion of a debt, there would be no need for subsection (b). If Congress had intended for the holders of both secured claims and unsecured claims to recover attorneys' fees, it could have easily said so. But it did not.

333 B.R. at 60-61.

Numerous other jurisdictions have likewise concluded

that unsecured creditors cannot recover legal fees incurred in a bankruptcy proceeding. See *In re Electric Machinery Enterprises, Inc.*, 371 B.R. 549, 550 (Bankr. M.D. Fla. 2007); *In re Global Indus. Techs., Inc.*, 327 B.R. 230, 239 (Bankr. W.D. Pa. 2005); *In re Hedged-Investments Assocs., Inc.*, 293 B.R. 523, 525-26 (D. Col. 2003); *In re Southeast Banking Corp.*, 188 B.R. 452, 462 (Bankr. S.D. Fla. 1995); *In re Woodmere Investors Ltd. P'ship*, 178 B.R. 346, 356 (Bankr. S.D.N.Y. 1995). These courts have tended to use four basic arguments to support the conclusion that legal fees are not allowable. First, they argue that by providing that a secured claim shall be allowed reasonable fees to the extent the claim is secured by property, the Bankruptcy Code implicitly denies fees to an unsecured creditor. Second, courts have found that the Supreme Court's decision in *Timbers*, disallowing post-petition interest to undersecured creditors, analogously leads to a finding that legal fees are also precluded. Third, courts denying fees take the position that Section 502(b), which requires a court to calculate a claim as of the

petition date, necessarily excludes fees accruing post-petition. Finally, courts assert that it would not be fair to allow unsecured creditors to recover legal fees because that would reduce the amount of assets available to other creditors who lack a contractual right to claim such fees.

Other courts have reached the opposite conclusion. See e.g. *In re Qmect, Inc.* 368 B.R. 882, 883 (Bankr. N.D. Cal. 2007); *Spence v. Joseph S. Knecht & Co.*, 194 Fed. Appx. 102 (4th Cir. 2006) (unpublished); *Spence v. Joseph S. Knecht & Co.*, 2005 U.S. Dist. LEXIS 43298 (D.S.C. 2005); *In re New Power Co.*, 313 B.R. 496, 510 (Bankr. N.D. Ga. 2004); *In re Welzel*, 275 F.3d 1308, 1319 (11th Cir. 2001); *In re Byrd*, 192 B.R. 917, 919 (Bankr. E.D. Tenn. 1996); *Liberty Nat. Bank & Trust Co. of Louisville v. George*, 70 B.R. 312, 317 (W.D. Ky. 1987); *In re United Merchants & Mfrs., Inc.*, 674 F.2d 134, 138 (2d Cir. 1982). These courts have reasoned that the validity of the creditor's claim for legal fees does not depend on whether the obligation is secured, unless state law so provides.

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Furthermore, they reason that if Congress had wanted to disallow claims for post-petition attorneys' fees, the logical place for it to have done so was in Section 502(b), which provides nine exceptions to the general allowance of claims but does not mention legal fees. Finally, in cases involving solvent debtors, these courts have argued that allowing a solvent debtor to retain funds without paying attorneys' fees to which the unsecured creditor would be entitled outside of bankruptcy would be inequitable.

The courts allowing legal fee claims offer the following rebuttals to the arguments advanced by courts which have refused to allow legal fee claims. First, they argue that while the Bankruptcy Code requires an estimate of the claim as of the date of filing, fees incurred during the post-petition period are allowable if the right to collect the fees existed prepetition. Second, as to the argument that Section 506(b) precludes fees because it only references secured claims, these courts argue that Section 506(b) simply does not address the issue of legal

fees incurred by unsecured creditors. Finally, courts allowing fees take the position that the Supreme Court's *Timbers* decision did not bar unsecured creditors from asserting a claim for fees as an unsecured claim because, as opposed to post-petition interest, there is no general rule excluding legal fees from unsecured claims.

The rough split in decisions — allowing fees or denying them — makes it difficult even to identify a majority view. See Goeffrey L. Berman and Peter M. Gilhuly, *Recovering Attorneys' Fees and Costs in Bankruptcy Cases*, 19-May Am. Bankr. Inst. J. 32 (2000) (allowing fees for unsecured claims is the majority approach); Mark Scarberry, *Interpreting Bankruptcy Code Sections 502 and 506: Post-Petition Attorneys' Fees in a Post-Travelers World*, 15 Am. Bankr. Inst. L. Rev. 611 (2007) (denying fees is the majority approach); Jennifer Taylor and Christopher Mertens, *Travelers and the Implications on the Allowability of Unsecured Creditors' Claims for Post-Petition Attorneys' Fees Against the Bankruptcy Estate*, 81 Am. Bankr.L.J. 123, 139-40 (2007) (neither is a true

majority approach).

The Supreme Court had a golden opportunity in 2007 to lay this issue to rest when it issued its *Travelers* opinion. However, it declined to do so even while specifically acknowledging the split of authority among lower courts. Instead, the Court limited its holding to overruling the dubious *Fobian* rule fashioned by the Ninth Circuit. That rule prevented creditors from recovering legal fees incurred in enforcing bankruptcy remedies but permitted claims for legal fees incurred in connection with enforcing state law claims. *Fobian v. Western Farm Credit Bank*, 951 F.2d 1149 (9th Cir. 1991).⁵ In *Travelers*, the Debtor, P, G & E, had a bond with *Travelers* to cover P, G & E's workman's compensation obligations. *Travelers* objected to the manner in which P, G & E proposed to handle its workman's compensation obligations in its plan of reorganization. P, G & E objected to allowance of *Traveler's* contingent reimbursement claim. Eventually the parties resolved their issues by settlement, but not before *Traveler's* had incurred legal fees totaling \$167,000.

The Supreme Court

found no basis in the Bankruptcy Code for the artificial distinction between recoverable and non-recoverable legal fees posited by the *Fobian* rule. Importantly, the Court noted that, under Section 502, there is a general presumption that claims allowable under state law will be allowed in bankruptcy unless the Bankruptcy Code expressly prohibits such claims.

Although the Court limited its holding to overturning the *Fobian* rule, the Court's analysis of the *Fobian* rule suggested that it was unsympathetic to the argument which the Debtor sought to advance in *Travelers*, i.e. that the language of Section 506(b) precludes the recovery of post-petition legal fees by unsecured creditors. The Supreme Court signaled that it was more sympathetic to an approach which presumed that the fees, if authorized by state law, would be allowable. It therefore rejected the approach followed by many courts which refused to allow legal fees in the absence of an affirmative provision in federal law authorizing the recovery of fees.

Not long after the

Supreme Court issued its *Traveler's* decision, the issue of the allowability of legal fees to an unsecured creditor was presented to Judge Anderson In *In re Gfroerer*. That case presented the rare circumstance in which a confirmed Chapter 11 plan provided for payment in full of all creditors. A secured creditor had satisfied a substantial portion of its claim by the liquidation of collateral by the debtor or by foreclosure, but was left with an unsecured claim. The creditor included in its unsecured claim substantial legal fees it had incurred during the pendency of the debtor's reorganization in Chapter 11. In *In re Gfroerer*, Judge Anderson, citing the Supreme Court's decision in *Travelers* and the opinion of the United States District Court for the District of South Carolina in *Spence v. Knecht*, 2005WL 560 1532 (D.S.C. 2005), *aff'd* 194 Fed. Appx. 102 (4th Cir. 2006) (*unpublished*), ruled that the legal fees were allowable.⁶ Judge Anderson noted that the Supreme Court had ruled that "bankruptcy law does not preclude on unsecured creditor from recovering attorney's fees by way of a valid claim under

Section 502(b) if the attorney's fees are authorized by a pre-petition contract with the debtor, even if the fees are incurred post-petition."

The *Travelers* decision was also front and center in a case decided by Judge Mitchell in the Eastern District of Virginia in 2007. *In re WCS Enterprises, Inc.* 381 B.R. 206 (Bankr. E.D. Va. 2007), the Court rejected the unsecured creditor's claim that *Travelers* supported its claim for legal fees incurred post-petition. The Court observed that the Supreme Court had limited its holding to a rejection of the 9th Circuit's *Fobian* rule and had declined to rule generally on the allowability of post-petition legal fees for unsecured creditors. The Court disallowed the claim for legal fees, holding that Section 506(b) "operates as a gloss on Section 502(b) to disallow contractual claims for post-petition attorney's fees."

According to Judge Mitchell, if Section 506(b) disallowed legal fees for undersecured creditors, totally unsecured creditors likewise are not entitled to legal fees. 381 B.R. at 209. The Court also cited to the

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Supreme Court's ruling in *Randolph v. Scuggs*, 190 U.S. 533 (1903), which held that an unsecured debtor's claim for legal fees could only be allowed for "services which were beneficial to the estate". 190 U.S. at 539. The Court noted that no such showing of benefit had been made.

Conclusion

It remains to be seen whether the dicta in *Travelers* or Judge Anderson's shift from his often-cited *In re Saunders* opinion will impact how other judges in Virginia will rule on this issue when it arises.⁷ Whether or not post-petition legal fees will be allowable as part of an unsecured claim obviously remains as unsettled as ever. ♦

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² For ease of reference, this article will refer to both unsecured creditors and undersecured creditors simply as "unsecured creditors"

³ Obviously, the inclusion of post-petition legal fees as part of an unsecured claim, even if allowed, does not mean that such fees will be recovered given the paltry amounts typically paid on

unsecured claims. However, at a minimum the ability to include such fees and increase the size of its claim could increase an unsecured creditor's relative voting power in a Chapter 11 reorganization and ultimately its pro-rata distribution. The impact would be much greater, of course, in the rare event of a plan providing 100% payment to creditors.

⁴ In *In re Miller*, 334 B.R. 769 (Bankr. W.D.Va. 2006), Judge Stone relied on the holding in *In re Saunders* in ruling that Section 506(b) limits recovery of legal fees only to holders of fully secured claims. In *In re Smith*, 206 B.R. 113 (Bankr. D. Md. 1997) the Bankruptcy Court for the District of Maryland, citing *In re Saunders* and Section 506, held that unsecured creditors may not collect legal fees. In *Ins. Co. of N. Am. v. Sullivan*, 333 B.R. 55 (D.Md. 2005) the District Court of Maryland followed the holding of *Smith* in finding that fees are only awarded to oversecured creditors based on the "express language" language of Section 506(b).

⁵ The underlying rationale for this rule was that legal fees are ordinarily not recoverable if incurred in pursuit of a federal right or cause of action unless specifically provided for by statute. In contrast, claims arising in pursuit of a state law right are often allowable pursuant to a contractual provision awarding legal fees to a prevailing party. In situations involving actions combining elements of both state and federal law (e.g. a creditor's non-dischargeability claim seeking both a ruling of non-dischargeability under federal bankruptcy law and a money judgment, several courts had allowed creditors to recover legal fees incurred in the non-dischargeability action based on contract provisions awarding legal fees to the creditor. However, the 9th Circuit had adopted a blanket rule against any allowance of fees incurred in pursuing remedies peculiar to bankruptcy.

⁶ In *Spence*, the District Court noted that two bankruptcy courts within the

Fourth Circuit (*In re Saunders* in Virginia and *In re Smith* in Maryland) had followed the "majority" view by disallowing legal fees claims by unsecured creditors. However, the District Court found the "minority" interpretation more reasonable. In the process it articulated the legal arguments as to why legal fees were allowable and debunked the arguments which had been relied on by courts which had disallowed legal fees claims.

⁷ The author did not find other post-*Travelers* opinions by Virginia judges on this issue. In other jurisdictions, it appears that the courts remain split. See, e.g., *In re Electric Machinery Enterprises, Inc.*, 371 B.R. 549 (Bankr. M.D. Fla. 2007) (disallowing legal fee claim by unsecured creditor based on usual arguments); cf. *In re Qmect, Inc.*, 368 B.R. 882 (Bankr. N.D. Cal. 2007) (allowing legal fee claim of unsecured creditor).